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Course Guidebook

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PUBLISHED BY:

THE GREAT COURSES
Corporate Headquarters
4840 Westfields Boulevard, Suite 500
Chantilly, Virginia 20151-2299
Phone: 1-800-832-2412
Fax: 703-378-3819
www.thegreatcourses.com

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Professor Michael A. Roberto is the Trustee Professor of Management at Bryant University in Smithfield, Rhode Island, where he has taught since 2006. Before joining Bryant, Professor Roberto served as a faculty member at Harvard Business School and as a visiting professor at New York University. He earned a bachelor's degree in Economics from Harvard College, as well as an M.B.A. with high distinction and a doctorate in Business Administration from Harvard Business School.

Professor Roberto's research focuses on organizational and team decision-making processes. He has focused extensively on the decision-making breakdowns that lead to large-scale organizational failures. His next book will focus on the challenges that established organizations face as they try to embrace the design thinking approach to creative problem solving and innovation.

The M.B.A. students at Bryant University have chosen Professor Roberto for the Excellence in Teaching Award on eight occasions. He also earned the Allyn Young Prize for Teaching at Harvard on two occasions. Professor Roberto's innovations in teaching with technology have earned several major awards. The *Everest Leadership and Team Simulation* won top prize in the eLearning category at the 16th Annual MITX Interactive Awards. This competition recognizes achievements in the creation of web and mobile innovations and emerging applications produced and developed in New England. Professor Roberto's multimedia case study about the 2003 space shuttle accident, titled *Columbia's Final Mission*, earned the software industry's prestigious CODiE Award in 2006.

Professor Roberto is the author of two books: *Why Great Leaders Don't Take Yes for an Answer: Managing for Conflict and Consensus* and *Know What You Don't Know: How Great Leaders Prevent Problems before They Happen*. He has published articles in the *Harvard Business Review*, *MIT Sloan Management Review*, and *California Management Review*. Professor Roberto also has taught two previous Great Courses: *The Art of Critical Decision Making* and *Transformational Leadership: How Leaders Change Teams, Companies, and Organizations*. ■

Thomas J. Goldsby, Ph.D.

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Professor Thomas J. Goldsby is the Harry T. Mangurian Jr. Foundation Professor of Business and Professor of Logistics at The Ohio State University's Fisher College of Business. He has held previous faculty appointments at the University of Kentucky, The Ohio State University, and Iowa State University. Professor Goldsby holds a B.S. in Business Administration from the University of Evansville, an M.B.A. from the University of Kentucky, and a Ph.D. in Marketing and Logistics from Michigan State University.

Professor Goldsby is coeditor in chief of *Transportation Journal*, the oldest academic journal in the field of business logistics; coeditor in chief elect of the *Journal of Business Logistics*, and co–executive editor of *Logistics Quarterly* magazine. He also serves as associate director of the Center for Operational Excellence, a research fellow of the National Center for the Middle Market, and a research associate of the Global Supply Chain Forum, all housed at Ohio State's Fisher College of Business. His research interests include logistics strategy, supply chain integration, and the theory and practice of lean and agile supply chain strategies.

Professor Goldsby has published more than 50 articles in academic and professional journals. He is recognized as one of the most productive researchers in the field of logistics management. Professor Goldsby is a recipient of the Best Paper Award at the *Transportation Journal* (2012–2013) and the Bernard J. LaLonde Award at the *Journal of Business Logistics* (2007). In addition, he has twice received the Accenture Award for Best Paper published in *The International Journal of Logistics Management* (1998 and 2002). He has received recognition for excellence in teaching

at Iowa State University, The Ohio State University, and the University of Kentucky. Professor Goldsby has supervised more than 100 Lean/Six Sigma supply chain projects with industry partners; chaired six Ph.D. dissertations; and served as an investigator on five federally funded research projects, exceeding $2 million in grant proceeds. He has fulfilled visiting professor assignments at the Politecnico di Milano (Italy), WHU-Otto Beisheim School of Management (Germany), and the Copenhagen Business School (Denmark).

Professor Goldsby is the coauthor of four books: *The Design and Management of Sustainable Supply Chains*; *The Definitive Guide to Transportation: Principles, Strategies, and Decisions for the Effective Flow of Goods and Services*; *Global Macrotrends and Their Impact on Supply Chain Management: Strategies for Gaining Competitive Advantage*; and *Lean Six Sigma Logistics: Strategic Development to Operational Success*. Professor Goldsby is a member of the selection committees for several industry awards, including Gartner's Supply Chain Top 25, the Council of Supply Chain Management Professionals' Supply Chain Innovation Award, *Logistics Quarterly*'s Sustainability Study and Awards Program, and the University of Kentucky's Corporate Sustainability Awards. ■

Eric Sussman, M.B.A.

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Professor Eric Sussman is a Senior Lecturer in Accounting and Real Estate at the University of California, Los Angeles (UCLA), Anderson School of Management, where he has taught since 1995. He received his M.B.A. from Stanford University with honors in 1993, after graduating summa cum laude from UCLA in 1987. He is a licensed CPA in the state of California.

Professor Sussman has received 13 Teaching Excellence Awards, voted on by Anderson's M.B.A. students, as well as the Citibank Teaching Award and the Neidorf "Decade" Teaching Award, both voted on by a committee of faculty members. In 2011, *Bloomberg Businessweek* recognized him as one of the 10 Most Popular Profs at Top Business Schools, and he has been named one of the 20 Most Influential Business Professors Alive Today by *Top Business Degrees*, a website devoted to business school rankings. In addition, Professor Sussman has advised numerous full-time and fully employed M.B.A. field study teams and has led student travel groups to Brazil, China, Dubai, Saudi Arabia, and Abu Dhabi. He teaches cost/managerial accounting, financial accounting (beginning through advanced), financial statement analysis, equity valuation, corporate financial reporting, and real estate investment and finance to undergraduate, graduate, and executive education students.

Professor Sussman has consulted for large and small firms, nationally and globally, and is a frequent lecturer on varied topics in financial, accounting, and corporate reporting. In addition, he created Insight FSA, an analytical software tool that automatically measures, evaluates, and reports on the financial accounting and corporate reporting risk for all

public companies via EDGAR Online. He also has served as an expert witness and consultant for commercial litigation involving matters of corporate financial reporting and disclosure, audit effectiveness, valuation, real estate due diligence and related practices, and overall damage analyses.

Professor Sussman is President of Amber Capital, Inc.; Manager of Fountain Management, LLC, and Clear Capital, LLC; and Managing Partner of Sequoia Real Estate Partners, LLC, and the Pacific Value Opportunities Funds, which have acquired, rehabilitated, developed, and managed more than 2 million square feet of residential and commercial real estate in the past 20 years. The firms' portfolio currently consists of industrial, multifamily residential, single-family residential, and retail properties.

He is Chairman of the Board of Trustees of Causeway Capital Management's group of funds (which collectively have in excess of $6 billion in assets); sits on the Board of Directors of Pacific Charter School Development and Bentley Forbes Group, LLC; and is former Chairman of the Presidio Fund and former Audit Committee Chair of Atlantic Inertial Systems, Inc., a producer and manufacturer of electromagnetic sensors. ■

Clinton O. Longenecker, Ph.D.

Stranahan Professor of Leadership and
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Professor Clinton O. Longenecker is a Distinguished University Professor and the Stranahan Professor of Leadership and Organizational Excellence in the College of Business and Innovation at The University of Toledo, where he has taught since 1984. He holds a B.B.A. in Marketing and an M.B.A. in Management from The University of Toledo, as well as a Ph.D. in Management from The Pennsylvania State University. Professor Longenecker also has served as a Visiting Lecturer at The University of the West Indies at Cave Hill, Barbados, and has lectured extensively in Poland, Hungary, and Russia.

Professor Longenecker's teaching, research, and consulting interests are in high-performance leadership and the creation of great organizations. He has published more than 180 articles and papers in leading academic and professional journals, including the *MIT Sloan Management Review*, *Industrial Management*, *Business Horizons*, *The European Business Review*, *Organizational Dynamics*, and others. He is a frequent media source, and his research has been featured in *The Wall Street Journal* and *Investor's Business Daily*, on MSNBC and NPR, and in a wide variety of other outlets.

Professor Longenecker is an active management consultant, educator, and executive coach. His clients represent a broad range of Fortune 500 firms and entrepreneurial organizations, including Harley-Davidson, ConAgra Foods, the SSOE Group, ProMedica Health Systems, Whirlpool Corporation, Eaton Corporation, Cooper Tire & Rubber Company, Dana Holding Corporation, the Howard Hughes Medical Institute, and O-I, Inc., among others. Professor

Longenecker has been described by Career Publications as "one of the top motivational speakers in the U.S. who can blend cutting edge research, common sense, humor and conviction into a real and inspiring call for better performance that can help us all!"

Professor Longenecker has received more than 40 outstanding teaching, service, and research awards and is the only professor in the history of The University of Toledo to have been the recipient of the university's Outstanding Teacher, Outstanding Researcher, and Outstanding Service awards. In addition, he has received numerous industry awards, including the Ernst & Young Entrepreneur of the Year Award, a Toastmasters International Leadership Award, and a Jefferson Award for outstanding public service. He has been recently recognized by *The Economist* as one of the top 15 business professors in the world.

Professor Longenecker's best-selling book, *Getting Results: Five Absolutes for High Performance* (coauthored with Jack Simonetti), describes the best practices of more than 2,000 high-performance managers and how they achieve outstanding performance; the book has been translated into nine languages. His latest book is *The Two-Minute Drill: Lessons for Rapid Organizational Improvement from America's Greatest Game*, published with Greg Papp and Tim Stansfield. The book chronicles the keys to rapid performance improvement from the authors' research on more than 1,000 organizational improvement initiatives. Professor Longenecker is also featured in a number of educational videos, including the award-winning CRM training film *Effective Performance Appraisal* and *Continuous Improvement in Manufacturing*, based on his research.

Professor Longenecker is an active community servant and a Bible study leader and Christian speaker. He has spent extensive time working in the country of Haiti, managing several missionary schools and hospital construction projects. He is happily married to the former Cindy Breese and has three children. ■

Ryan Hamilton, Ph.D.

Associate Professor of Marketing
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Professor, Critical Business Skills: Marketing

Professor Ryan Hamilton is an Associate Professor of Marketing at Emory University's Goizueta Business School, where he has taught since 2008. He received his Ph.D. in Marketing from Northwestern University's Kellogg School of Management. He also has a B.S. in Applied Physics from Brigham Young University, where he participated in proton-induced X-ray emission research using a Van de Graaff proton accelerator.

Professor Hamilton is a consumer psychologist, whose research investigates shopper decision making: how brands, prices, and choice architecture influence decision making at the point of purchase. His research generally fits within the school of behavioral decision theory, examining how contextual factors produce decision biases and irregularities. In 2013, he was recognized by the Marketing Science Institute as being among the most productive young scholars in his field.

Professor Hamilton has received multiple teaching excellence awards from his M.B.A. students at Emory and, in 2011, was named one of "The World's Best 40 B-School Profs under the Age of 40" by *Poets & Quants*, an online magazine that covers the world of M.B.A. education.

Professor Hamilton's research findings have been published in some of the most prestigious peer-reviewed journals in marketing and management, including the *Journal of Consumer Research*, the *Journal of Marketing Research*, the *Journal of Marketing*, *Management Science*, and *Organizational Behavior and Human Decision Processes*. His findings also have found an audience in the popular press, having been covered by *The New York Times*, *The Wall Street Journal*, *TIME*, *USA TODAY*, *The Financial Times*, *New York* magazine, and CNN Headline News.

Professor Hamilton is the proud father of five young children, which means that he spends much of his time exhausted and slightly rumpled. He is also a former amateur sketch and stand-up comedian and performed in that capacity in clubs and on college campuses across the country. ■

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Critical Business Skills: Strategy

Michael A. Roberto, D.B.A.

Critical Business Skills: Strategy

Scope:

Successful businesses formulate a clear competitive strategy. They make the tough choices about how and where to compete. These firms do not try to be all things to all people. Instead, they select their target markets carefully, and they choose what not to do. By making clear trade-offs, they develop a distinctive position in the marketplace, and they make it quite difficult for established rivals to engage in successful imitation.

In this section of the course, we will explore the fundamental question: Why do some firms perform better than others? To answer this question, we will examine two factors: industry attractiveness and competitive advantage. We will learn that some industries earn much higher returns on investment than others. In the first six lectures, we will introduce a framework for analyzing industry structure and explaining the substantial differences in profitability across industries. Of course, companies can earn higher returns than their competitors by building competitive advantage within whichever industry they choose to compete. We will examine how firms establish a distinctive competitive position and create competitive advantage over rivals. Moreover, we will analyze how firms can sustain that competitive advantage against a variety of external and internal threats. Most firms cannot sustain advantage for a lengthy period of time. We will try to understand why and how leading companies lose their competitive edge.

The second six lectures shift focus from business strategy to corporate strategy. The latter topic emphasizes the strategic choices faced by diversified, multi–business unit companies. We will examine why these firms choose to expand their horizontal and vertical scope. In this section, we ask the fundamental question: Is the whole worth more than the sum of the parts? In other words, how can companies create (or destroy) value by choosing to own and operate multiple business units competing in different product markets? This section of the course closes by examining the role

of the entrepreneur. We examine how start-ups can use a lean approach to launching a new business, while applying many of the strategic concepts introduced in these lectures.

Throughout the lectures, we will use a wide variety of case studies to introduce key concepts from the field of competitive strategy. For instance, we will examine the dynamics of such industries as airlines, personal computers, and pharmaceuticals. We will look at how such firms as Apple have positioned themselves to succeed in challenging competitive environments. We will explore how Trader Joe's made a series of trade-offs to establish a position that others could not imitate easily, and we will analyze the competitive battle between Blockbuster and Netflix. We will also explore the diversification and vertical integration strategies used by such firms as Disney and Zara. As we examine these case studies, we will see how the core ideas of business strategy work in practice, not just in theory. ■

Strategy Is Making Choices

Lecture 1

Andy Grove, the CEO of Intel, has noted that in business, only the paranoid survive. As proof of this idea, consider what has happened in just a few industries in recent years: The movie rental business Blockbuster has been toppled by Netflix; record stores have given way to music-streaming services, such as Spotify; and taxicabs may soon be supplanted by Uber. In each of these industries, a disruptive rival has emerged and threatened or eliminated the incumbent players. In this section of the course, we will try to understand how you can sustain a competitive advantage in your industry or how, as a new entrant, you can plot a strategy to knock off the top players.

The Field of Business Strategy

- The field of business strategy might be said to have emerged from an ancient Chinese military treatise, *The Art of War*, written by Sun Tzu. Many in business have used this text to formulate ideas on how companies can build and sustain competitive advantage.

- In the 1950s and 1960s, leading business schools began to explore the idea of competitive strategy. In the early 1960s, the business historian Alfred Chandler studied some of America's great 20th-century corporations. He noted that as those firms changed their strategies, they also had to change their organizational structures, systems, and processes. For this reason, he argued that strategy drives structure in large organizations.

- But in 1970, Joseph Bower at Harvard Business School turned that argument on its head. He didn't disagree with Chandler, but he argued that in some companies, structure can also drive strategy. The choices a firm makes regarding systems, organizational structures, processes, measurements, and so on can drive the firm's future. Such choices are behind the kinds of ideas that bubble up from below about new products and services and reach top management.

- The modern field of strategy was initiated by Ken Andrews and his colleagues at Harvard Business School. They argued that strategy is a pattern of choices that reveals the purpose and goals of an organization.

- Economics has also influenced the field of strategy. Michael Porter was one of the early economists who began to fuse ideas from economics with ideas from the field of business management.

Organizational Performance

- The fundamental question we'll try to answer in these lectures on strategy is simple: Why do some firms perform better than others? To answer this question, we must look at two factors: industry attractiveness and competitive advantage.

- Industry attractiveness simply means that some industries are more profitable than others. In those environments, there are more opportunities for more companies to make healthy returns. In other industries, it's much more difficult for firms to make money. Thus, one part of explaining a firm's performance is understanding the environment in which it competes.

- But we also then have to understand how a firm competes against its rivals. Does it have an advantage over rivals? Is it able to generate returns above the industry average? And can it do so year after year? That's what we mean by competitive advantage.

- We can also identify two key questions related to competitive advantage: (1) How do you establish a distinctive competitive position and create advantage over your rivals? (2) How do you sustain that advantage against a variety of external and internal threats?
    - We live in a world where information is readily available and moves quickly. Anyone can get on the Internet and learn about competitors. Consultants can be hired to help benchmark a firm against the competition.

- Without question, if you've proven that you have a successful product or service, if your customers are happy and your investors are getting attractive returns, others will try to imitate you. They will look for a slightly better way to do what you're doing—and they won't stop.

- For this reason, understanding how to sustain competitive advantage is crucial to business strategy.

Strategic Planning

- Porter has argued for the importance of having an explicit process for formulating strategies, for understanding the goals of a corporation and how they will be achieved. But some have been much more skeptical and critical of the idea of strategic planning in organizations. For example, management professor Russell Ackoff said, "Most corporate planning is like a ritual rain dance. It has no effect on the weather that follows, but it makes those who engage in it feel that they are in control."

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In many corporate strategic planning processes, discussions focus more on financial targets and budgets than about where and how to compete.

- It's important to note that Ackoff is criticizing the strategic planning process as it occurs in many companies. That process, especially in large organizations, tends to be bureaucratic and cumbersome. It takes a great deal of time, and it tends to focus on budgeting rather than strategy. In contrast, strategy formulation should focus on where and how to compete.

- Some have also criticized the field the strategy by arguing that it's simply not appropriate to talk about establishing and sustaining competitive advantage in today's turbulent environment.
    - Rita McGrath at Columbia has said that competitive advantage is transient. It's simply too difficult, she says, for firms to establish an advantage and sustain it over a long period of time.

    - According to McGrath, firms must adapt constantly, managing a pipeline of initiatives, not just one strategy. Any organization should experiment, iterate, and learn. Adapting is what great firms do, not plotting a distinctive position and trying to sustain it.

- Roger Martin from the University of Toronto disagrees with McGrath. Strategy, he says, should not be confused with strategic planning processes. Yes, your organization should adapt and iterate, but you must begin with a clear set of choices. You must know the direction in which you're headed. From there, you can adapt. But many managers, according to Martin, embrace the adaptive view because they don't want to make hard choices.

- Both Martin and McGrath fundamentally agree that strategy ultimately comes down to making choices about what to do and what not to do. And Martin would agree with McGrath that competitive advantage is more fleeting today than it was decades ago. But Martin believes an organization must start with a clear direction; from there, managers must scan the market, the customer, and the competition and be ready to flex the strategy appropriately.

- It's generally not the case that strategy formulation is explicit, conscious, and purposeful. It's more often the true that strategy emerges and evolves over time. It's important to think about strategy as a pattern in a stream of decisions and actions; it's not an event but a process.

- The authors of *Playing to Win* have noted five key questions to ask yourself when plotting strategy:
    - What's your winning aspiration? In other words, what are you trying to achieve?

    - Where will you play—in what product markets, segments, and geographies?

    - How are you going to win? That is, what are you going to do that will give you an advantage over the competition?

    - What capabilities must be in place to execute your strategy?

    - What management systems are required to implement your strategy?

Competition

- Four facts about competition will set the stage for our analysis of competitive environments as we move through these lectures. First, industries vary widely in their profitability. That is, in some businesses, it will be difficult to make money no matter how smart the management team or how great the strategy.

- Second, the industry you're in matters a great deal; in other words, sometimes there are forces beyond your control driving your profitability. Those in the newspaper business, for example, have learned this lesson as the Internet has grown.

- Third, competitive advantage may be fleeting.

- Fourth, industry structure varies widely around the world. It's true that we live in a more global world today, but competitive environments can look very different in different parts of the world for a variety of reasons, from consumer tastes and culture to government regulation and institutions.

Industry Structure and Competitive Advantage

- In 2013, the return on assets for Pfizer, a pharmaceutical company, was 12.8%. For Alaska Airlines, it was 8.7%. Can we conclude that Pfizer is a better-managed firm than Alaska Airlines? No, we can't look only at absolute financial returns to make conclusions about these two companies.
    - The pharmaceuticals industry is high profit, while the airlines industry is low profit. If we look more deeply, we would learn that Alaska Airlines outperforms rivals in its industry.

    - That's the key comparison we need to make. We're looking for companies that generate excess returns relative to the industry average; that's competitive advantage.

- As we look across industries, we also see that in some industries, the leader in one year is much more likely to stay on top than the leader in other industries. In other words, competitive advantage is fleeting, but it's more fleeting in some industries than others.

- The fact that you're in an industry that's low profit doesn't mean you can't make money.
    - In the supermarket business, many firms generate returns on assets in the low single digits, but if we look at the major competitors, we still see variation in returns. For example, in 2012, Whole Foods generated an 8% return on assets, while Kroger generated 2.6%. Even though the industry as a whole generates thin margins, we see wide variation across major competitors.

- This tells us that Whole Foods has found a way to build a strong competitive advantage in an otherwise structurally unattractive business. In the coming lectures, we'll look at a number of companies that have done just that. As we'll see, we can learn more about strategy by studying companies in tough businesses to identify how they achieved a distinctive position than we can by looking at companies that compete with many other players that also generate healthy earnings.

Suggested Reading

Arbesman, "Fortune 500 Turnover and Its Meaning."

Lafley and Martin, *Playing to Win*.

McGrath, *The End of Competitive Advantage*.

Questions to Consider

1. Should firms establish a long-term strategy, or should they embrace a more adaptive approach to management?

2. Why do many strategic planning processes fail to produce positive results?

3. Why is it so difficult for firms to sustain high performance?

How Apple Raises Competitive Barriers

Lecture 2

Richard Branson, the British entrepreneur and successful founder of the Virgin Group, once joked that it's rather easy to become a millionaire; you simply start as a billionaire, then go into the airline business. Warren Buffett, in his analysis, found that the airline industry as a whole has lost money for the last 100 years. What explains the difference between the notoriously low-profit airline industry and high-profit industries, such as pharmaceuticals? In this lecture, we'll look at Michael Porter's seminal work on the five forces that shape strategy, which offers a comprehensive framework to help understand these differences in profitability across industries.

The Five Forces

- The first of Michael Porter's five forces shaping strategy is barriers to entry. As Porter argued, high barriers to entry improve the profitability of an industry.

- The second force is the threat of substitutes, that is, alternative products or services that fulfill the same need. These may not always be direct rivals but, in some cases, quite different products or services than the ones you're selling. For example, substitutes for fitness centers might include home workout equipment, diet plans, video game systems for exercising, and even local bars, because some people join fitness centers for social purposes.

- The third force shaping strategy is the bargaining power of suppliers. Who provides the key inputs and components for your product or your firm, and do those suppliers have leverage over you? Can they extract some of the profits you might otherwise make?

- The fourth force shaping strategy is the bargaining power of the customer. Again, who has the leverage in the buyer-seller relationship?

- Finally, the fifth force is rivalry among existing competitors. In particular, it's important to consider whether firms in the industry compete hard on price. Are there frequent price wars in the industry, or is the environment one of friendly competition, perhaps one in which competitors engage in mutually beneficial activities?

Applying the Framework: Airlines

- At first glance, barriers to entry might seem high in the airline industry, yet over the past few decades, the industry has seen many new players. In fact, the barriers aren't as high as they initially appear. A new entrant can lease old planes rather than buying new ones. In addition, entrants don't have to fight for slots at large, expensive airports but can easily gain access to regional airports, where states and counties are trying to draw traffic for economic development and tourism.

- However, buyer power in the airline industry is high. Customers don't see much differentiation in airlines and aren't particularly loyal. Moreover, air travel customers are highly price sensitive, and they can look for bargains on travel websites, which offer perfect price transparency.

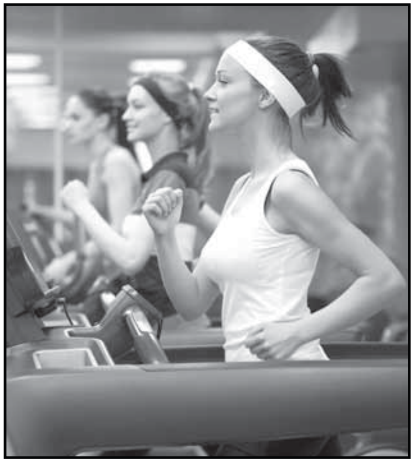
- Supplier power is also high. Airbus and Boeing provide jumbo jets and a few other players provide regional jets, but there aren't many alternatives when it comes to buying planes. As for labor, airlines have to negotiate with powerful unions. And the price of fuel is driven by OPEC.

- These days, there are also numerous substitutes for air travel, including other forms of transportation, such as cars or trains, and technology, such as video conferencing, which allows businesspeople to avoid traveling to meetings.

- Finally, the airline business has a unique characteristic that drives intense price competition: The business has very high fixed costs and virtually no variable or marginal costs.

- Getting the plane in the sky involves all fixed costs; there is very little expense that varies depending on how many passengers are on the plane.

- In that situation, anything an airline receives above zero is what's called *contribution margin*—dollars that could go toward covering fixed costs or toward profitability. Thus, there is intense price competition to try to fill seats.



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With the drive to reduce obesity, fitness centers have been seen as an attractive business, but in fact, overall, this industry hasn't generated much profit.

- As you can see, the five forces framework is useful for examining the competitive environment in a systematic fashion. If, for example, consumer tastes or technology are changing in a substantial way, the framework can be used to help understand the potential impact of those changes on profitability.
  - You can also use the framework to think about how you might position your company to deal with threats. In a tough industry, can you find a segment that is, perhaps, a little more profitable, allowing your business to thrive when others are losing money?

  - Finally, you might be able to think about how your firm, as a leading company in the industry, might shape a more favorable industry structure. Can you, perhaps, raise barriers to entry, thereby increasing your own profitability and making the environment better for all?

The Spectrum of Competition

- Economists, such as Porter, typically examine the behavior of firms in the economy by building models of perfect competition. These models usually encompass the following assumptions: There is free entry and exit into the business; there are many buyers and sellers, all of which are relatively small and equal in size; complete information is available about the goods and services; the goods are homogeneous; and each firm is trying to maximize profits. Economists argue that the result of perfect competition is maximum social welfare.
    - Economic profits in this world of perfect competition equal zero, although that's not to say that firms make no accounting profits.

    - Accounting profits do not include opportunity costs for the labor and the capital that are deployed in a firm, while economic profits account for opportunity costs.

- In the past, economists who studied industrial organization tended to examine markets characterized by imperfect competition from the perspective of the consumer. They were looking for antitrust issues. Were there instances of imperfect competition where firms might be engaging in behavior that harms consumers or diminishes social welfare?

- Porter, however, looked at markets from the perspective of a company and found that businesses want imperfect competition. They don't want economic profits to be zero, but they also don't want to create antitrust concerns. Thus, he reversed the assumptions of perfect competition.

- According to Porter, CEOs should look for businesses where there are barriers to entry and exit. Further, the goods should not be homogeneous but differentiated. Those who can find these imperfections in an industry—or help shape them—can drive economic profits higher. And that's what you're looking for as you shape strategy.

- Of course, what we're thinking about here is really a spectrum of competition. On one end, we have many buyers and sellers, homogeneous goods, and no barriers to entry. On the other end, we have one firm with 100% market share. In between, we might have a number of situations, including fragmented markets with buyers and sellers of different sizes; an oligopoly, with three or four dominant players in an industry; and so on.

Steps in a Five Forces Analysis

- The first step in a five forces analysis is to define the industry you wish to analyze.

- The next step is to identify the players, including the buyers, suppliers, and rivals. When you're looking at buyers, remember to think about all the buyers, not just the end user but the distributor, retailer, and others along the supply chain.

- Next, you should assess the strength of each force using quantitative evidence. Look at the profitability of other companies in the business.

- Finally, you can't look to the past only; you must look forward, trying to understand the critical trends within the business. How can you project, based on your assessment of the environment, where each of the forces will be in the years ahead?

Crafting Strategy with the Five Forces

- One of the applications for the five forces framework is to craft a strategy that mitigates the negative forces in an industry. Consider, for example, Apple, which is in an industry with low barriers to entry, high buyer and supplier power, intense rivalry, and multiple substitutes.

- One way Apple mitigated these negative forces was to construct its own operating system. This step made it difficult for others to enter Apple's market and become direct competitors.

- Further, the Apple operating system fundamentally differentiates the company's products, making the products easier to use. And the operating system mitigates the power of Microsoft; Apple is not dependent on buying Windows, as other PC makers are.

- Apple also established its own stores, which mitigates the power of the big-box retail chains and online retailers.

- As for substitutes, Apple has been willing to cannibalize itself—to build tablets and smartphones. The company has gotten into the substitute business for its own products, rather than letting others do so.

Common Mistakes with the Framework

- One common mistake in five forces analysis is to apply the framework to a company, rather than an industry. In addition, management teams may not define the industry clearly when they begin to do their analysis.

- It's also common for managers to spend too much time looking back, rather than trying to understand the trends that might affect the future. Some managers might also ignore the full range of substitutes.

- Note, too, that you can't give equal weight to all five forces, thinking that if four of the five are in your favor, your business is in good shape. Even one negative force can cause harm.

- As we said, you can't presume that industry structure is the same around the world. For example, in Australia, several firms dominate the wine business, while in France, there are more than 200,000 independent wineries. It would be difficult to do a single five forces analysis for the global wine industry.

- Finally, it's important to take into account the limitations of the framework: It works primarily for industries where there are clear boundaries, it provides limited tools and techniques for understanding the nature of rivalry, and it doesn't address the issue of complements—a product or service that adds value to the original product offering when the two are used together.
    - Gillette pioneered the business model of complements. The company sells razors at a low cost because it knows that if customers like the razor, they'll buy blades forever.
    - Apple turned this traditional razors-and-blades strategy around when it entered the iPod, iPhone, and iPad market.
    - Before the iPhone, people paid very little for phones. How, then, has Apple induced customers to pay $400 or more for phones? Ask yourself: How do you get people to buy expensive peanut butter? By giving them lots of cheap jelly. And that's what Apple has done with its free and low-cost apps.

Suggested Reading

Brandenburger and Nalebuff, *Co-opetition.*

Porter, *Competitive Strategy*.

Questions to Consider

1. Why do some industries generate much higher profits than others?

2. What types of strategies can firms use to mitigate negative aspects of industry structure?

3. What are some examples of firms for which complements are a crucial element of strategy?

The Danger of Straddling

Lecture 3

What's different about the competitive strategies of Dell, Mercedes, and JCPenney? Dell tries to be the low-cost player in the personal computer market, while Mercedes tries to be a differentiated player in the automobile market. JCPenney seems to be stuck in the middle—achieving neither a low-cost strategy nor a differentiation strategy. As we've discussed, strategy involves understanding your competitive environment, then positioning yourself for success in that environment. In the last lecture, we saw how to understand the environment by conducting a five forces analysis. In this lecture, we'll try to understand the resources and capabilities that will enable you to succeed in that environment.

Creating Economic Value

- Professor Robert Grant wrote that strategy is concerned with matching a firm's resources and capabilities to the opportunities that arise in the external environment. As you do this—as you plot your strategy and try to position yourself—you're trying to create a competitive advantage relative to your rivals. To do that, you must create more economic value than your rivals.

- What does it mean to create economic value? When you produce and sell a good or service, customers have a certain perceived value for that good and service. There is also a cost, of course, for you to deliver that product or service to customers. The perceived value less the total cost equals the economic value created.

- Of course, the company that provides a good doesn't get all of the economic value created. That value is split between the company and the consumer.
  - Anything consumers pay that's less than what they're willing to pay—less than what they perceive as the value for that good—is surplus to them. That's part of the economic value that they get.

  - Any price or revenue that the company can achieve that's higher than the cost of producing and delivering the good is surplus, or profit. And the goal of a firm is to generate more economic value than the competition. That's what we mean by achieving competitive advantage.

Fundamental Strategy Choices

- There are three basic types of competitive advantage that firms can strive to achieve: low cost, differentiated, or dual.

- In addition, competitive scope can be categorized into two basic types:
  - A firm might be a *niche competitor*, competing with a fairly narrow product line and focusing on a particular geography and a small target market.

  - A firm might also choose to be a *broad competitor*, offering a wide array of products, competing in an expansive geographical setting, and serving a wider target market.

- These are the fundamental choices that firms must make as they choose strategy: What type of advantage does the firm seek, and how focused or broad will it be in terms of product, geography, and customer?

Competitive Advantage

- In thinking about competitive advantage, we start with the average competitor in an industry and the amount of economic value it creates. What is the gap between the willingness to pay for this competitor's product and the cost to deliver that product to customers? In trying to achieve competitive advantage, you want to generate a larger gap between willingness to pay and cost than your competition.

- For example, Mercedes tries to generate much higher willingness to pay than Chevrolet. Of course, costs for Mercedes are higher than they are for the firm's competition. If Mercedes wants to be a successful differentiated player, it will seek a much higher

willingness to pay but only slightly higher costs, so that the gap between willingness to pay and cost is higher than it is for the competition.

- A successful low-cost player tries to drive its costs much lower than those of its rivals. In the process, the low-cost player sacrifices a bit of willingness to pay.

- A third way to achieve competitive advantage is the dual strategy, with both a higher perceived value and a lower cost structure than the competition. This dual advantage is extremely difficult to achieve.
    - A firm that's trying to achieve higher willingness to pay and create more perceived value will have higher costs. It will to have to invest in research and development, branding, and high-quality components. It's difficult to have much lower costs than the competition if you're trying to create a premium product.

    - Likewise, if you're trying to bring your costs down significantly, it may be difficult to command the same brand image and position in the market and be able to achieve the same pricing.

    - With a dual strategy, players that are focused on either differentiation or low cost may be able to attack you. If you're trying to sell a vehicle at a high price, yet you're trying to achieve lower costs than the competition, Mercedes may critique the quality of your vehicles. Similarly, another player may have a strong cost position and be able to undercut you on price.

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A high-end clothing store might generate high gross margins, have higher expenses, and accept lower inventory turnover than a more mainstream retailer.

- Interestingly, a firm's financials often tell us what type of competitive advantage it's trying to achieve. For example, consider the financials of Walmart relative to Target.
  - Walmart has much lower gross margins than Target; lower overhead costs; and lower selling, general, and administrative expenses, but it has much higher asset turnover than Target.

  - Target's high gross margins and lower turns paint a picture of a typical differentiation strategy. Target has higher margins because it has chosen to sell slightly higher-quality goods—more fashionable items—and sets higher prices in some categories. Target has lower inventory turns because it sells fewer of the basics than Walmart.

Competitive Strategies

- Thus far, we can see that there are four generic competitive strategies:
  - Broad differentiated, used by Starbucks, for example. Here, we see a firm with a wide target market, competing in many geographies with a premium-priced (differentiated) product.

  - Focused differentiated, used by the motorcycle manufacturer Ducati. This Italian firm serves a narrow target market with a limited selection of products.

  - Broad low cost, used by Walmart, which serves a wide range of customers in many geographies with many products and services.

  - Focused low cost, used by the Irish airline Ryanair. This carrier serves certain geographies with a well-defined product set and a much narrower target market than major airlines.

- None of these strategies is "the best"; the mistake firms make in choosing strategies is to be unclear about where the firm is situated—to be stuck in the middle. This situation can occur when

firms fail to choose a strategy, try to shift strategy but don't make the shift successfully, or react inappropriately to the emergence of a new competitor.

Competitive Advantage as a System

- We need to think of competitive advantage as an integrated, self-reinforcing system of capabilities, resources, and choices. With this mindset, crafting an effective strategy means that your firm must be different; you can't simply copy the assortment of resources and capabilities that your rivals have achieved.

- The idea behind thinking of competitive advantage as a system is that one choice you make enhances the value of other choices, and one capability you develop creates stronger capabilities elsewhere. If these capabilities and choices fit together well, not only can you create a powerful advantage, but it can also be difficult for others to copy your system.

- Consider, for example, some of the early choices made by Walmart: an everyday low-price strategy, little national advertising, a focus on rural locations, a network of stores built around distribution centers, frugal travel policies, and no regional offices. Each of these choices reinforced other choices. For example, having an everyday low-price strategy fits well with not doing much national advertising.

- Competitors often look at what they think a firm does best and try to emulate that one part of the system. For example, a competitor might try to emulate Walmart's supply chain or logistics, but there are two mistakes inherent in this approach.
    - First, it isn't one thing that Walmart does that's a silver bullet. It's how Walmart's logistics plan and system fit with everything else it does that creates advantage.

    - Second, any potential competitor has its own system of activities that's quite different than Walmart's. Choosing one element of Walmart's system and trying to drop it into another system won't achieve the same advantage.

- Even a firm with a well-integrated, successful system may face difficulties if it tries to move into a new segment. This has been the case with Walmart's attempt to move into the wholesale club business with Sam's Club. Although Sam's Club is profitable, it is outperformed by Costco because Sam's Club is too tied to the legacy of Walmart to truly serve the different set of customers who shop at wholesale clubs.

- Another problem firms face when they have successfully tailored their activities to a particular environment is rigidity. They become committed to past choices and unable to adapt if the environment changes.
  - Because core capabilities can become rigid, successful entrants to an industry are often able to use the incumbent's strengths against it. Dell used this *judo strategy* when it took on IBM.

  - IBM had tremendous manufacturing capability to produce high volumes of its standardized products at low cost. It also had well-developed relationships with its distribution channel—retailers, wholesalers, and value-added resellers.

  - Dell built its strategy in such a way that these strengths of IBM became liabilities. IBM couldn't go direct and sell online because if it did, it would alienate many of its wholesalers and retailers. Further, IBM's factories weren't configured to build customized products.

Threats to Competitive Advantage

- The ability to be successful as a firm, to be more profitable than your rivals, is about not just achieving advantage but sustaining it. And to sustain advantage, you have to address three major external threats: imitation, substitution, and holdup (gaining leverage) by buyers and suppliers.

- Internally, firms face the threat of not perceiving and reacting adequately to threats. Incumbent players sometimes don't see a threat early enough, don't know how to respond, or can't motivate their organizations to respond quickly enough when threats emerge.

- One final threat is the risk of engaging in herd behavior. In many markets, companies aren't trying to be as different as they could be. This stems from risk aversion on the part of executives. If strategy is about identifying different activities and different positions in the marketplace, herd behavior is the antithesis of great strategy.

Suggested Reading

Ghemawat and Rivkin, "Creating Competitive Advantage."

Montgomery, *The Strategist*.

Porter, *Competitive Advantage*.

Yoffie and Kwak, *Judo Strategy*.

Questions to Consider

1. How and why do firms end up "stuck in the middle" in terms of competitive positioning?

2. Why is it so difficult for rivals to copy such a firm as IKEA?

3. Why do successful firms sometimes struggle when they move into adjacent markets?

What Trader Joe's Doesn't Do

Lecture 4

Suppose that several decades ago, a Stanford M.B.A. named Joe Coulombe asked you to invest in his new grocery retailer. He planned to open small stores in low-rent strip malls, offer a limited selection of goods, and do very little advertising. You probably would have made the mistake of turning down that investment, as many others did. But Coulombe went on to open a chain called Trader Joe's that became one of the most successful grocery retailers in the last few decades. In this lecture, we'll explore how Coulombe created a business where people want to work, customers want to shop, and investors want to put their money.

The Importance of Trade-Offs

- Unlike most other grocery stores, Trader Joe's doesn't offer many branded products; almost all of its products are private label. Its stores don't have large parking lots or wide aisles. It doesn't offer self-checkout, accept coupons, or have a loyalty card. It doesn't really run sales, doesn't advertise on television, and doesn't have a large selection of items. Finally, there is no stable product line at Trader Joe's.

- As Michael Porter once wrote, "The essence of strategy is choosing what not to do." You can't be all things to all people, which means that you have to choose not just what you will do but what you won't do. You need to have a clear understanding of the things your rivals offer that you choose not to offer. Such trade-offs make your firm distinct from your competitors, make it hard for existing players to imitate you, and can help you mitigate the negative forces in your industry.

- Some of the leading firms in past decades have achieved success by making firm choices about what they would not do and emphasizing those trade-offs.

    - Southwest Airlines, for example, doesn't offer assigned seats, uses smaller regional airports, has only one kind of plane in its fleet, doesn't allow customers to transfer bags to other airlines, and doesn't operate a hub-and-spoke system. Southwest has chosen not to do what many major airlines have done.

    - Likewise, Planet Fitness has positioned itself as a gym for people who aren't fitness nuts, and it emphasizes this trade-off approach in its advertising. By doing so, the firm hopes to attract customers who are more casual about their fitness regimes, those who want to lose a few pounds but don't want to be intimidated by bodybuilders.

Preventing Imitation

- Because of the trade-offs it has made, Trader Joe's has made it difficult for other grocery retailers to become imitators. Consider Kroger, for example, a large supermarket chain. Kroger has made historical commitments that are rigid. It already has large stores with wide aisles, and it can't change that format to mimic Trader Joe's. Kroger also has many branded goods and offers sales each week. It couldn't easily shift to everyday low pricing. To some extent, Kroger is stuck with the choices it has made.

- Moreover, the mindset of people operating a typical grocery store is quite different than the mindset of Trader Joe's leadership, and it's difficult to change mindset, as well. Tesco, a British retailer, tried to set up a separate subsidiary to build a chain of smaller-format stores to compete directly with Trader Joe's. But Tesco ended up stuck in the middle—creating something that was neither as good as Trader Joe's nor as effective as its main business.

Mitigating Negative Forces

- Trader Joe's strategy of making trade-offs has also helped the store mitigate negative forces in terms of industry structure.

- The unique array of private-label products that are unavailable at other retailers diminishes both buyer power and competitive rivalry. When you're not selling the same goods that other stores sell, people can't compare prices, and you don't get dragged into price wars.

- The distinctive in-store experience at Trader Joe's mitigates both buyer power and rivalry, and it helps to counter the threat of substitutions from other retail formats, including e-commerce. The everyday low pricing strategy also minimizes price rivalry and buyer power.

- In addition, Trader Joe's willingness to alter its product mix frequently mitigates supplier power. The store maintains a credible threat with regard to discontinuing products. Because customers don't know who makes the private-label items for Trader Joe's, the firm can also readily change its suppliers to get a better price.

- Finally, locating stores in older strip malls offsets the power of real estate firms and landlords that charge high rents to many retailers.

The Growth Trap

- The *growth trap* is a primary reason that other firms don't make trade-offs. CEOs want to grow revenue, and they believe that trade-offs could constrain growth. Obviously, as you make trade-offs, you narrow your target market, which makes it difficult to grow sales aggressively.

- Publicly traded firms definitely feel pressure to meet Wall Street expectations. But it's also true that large firms get more publicity, and their executives often receive higher compensation. Thus, there are some personal interests driving the obsession with growth for many companies.

- There's also a real challenge when CEOs set aggressive growth targets. What does it mean if a CEO sets a target of 15% or 20% growth per year?

- Mathematicians have a rule of 72 that helps us think about the growth of any number. If we divide 72 by the growth rate that a firm aspires to achieve, we get the number of years it will take for that firm to reach its target.

- If a firm is trying to grow at 20% per year, it will take about 3.5 years for that firm to reach its target. How is a firm that might have been around for 40 or 50 years going to achieve 20% growth in such a short period of time? In many cases, it does so by violating key trade-offs it originally made.

- A firm might have started with a long list of things it didn't plan to do—things that made it distinct but create a narrow target market. To go beyond that market, the firm begins to eliminate a few of the trade-offs.

A Dual Advantage Strategy?

- Some observers have pointed to Trader Joe's as an example of a firm pursuing a dual advantage strategy, achieving both differentiation and low costs. However, the reference point here is crucial.

- If we compare Trader Joe's to a typical supermarket, it might seem to have slightly higher prices and lower costs. But in comparison to other organic or natural stores, such as Whole Foods, Trader Joe's prices are clearly lower; therefore, it's hard to argue that the store is a differentiated player.

- The bottom line is that it's difficult to come to a definitive conclusion about the issue of dual advantage with Trader Joe's because it's not a publicly traded company. We don't have financial data on the company, and because it offers private-label goods, it's difficult to even assess the price level at the firm. We can't tell if Trader Joe's prices are lower than those of a given competitor because the products are not identical in both locations.

- This issue of dual advantage highlights the fact that many people confuse the term *differentiation* with the general notion of being different than the competition. Low-cost players can be highly distinctive, but that doesn't mean they're differentiated in the precise way that Porter initially defined the term. In the original generic strategies framework, *differentiation* meant creating a larger wedge between willingness to pay and costs than the average rival.

Blue Ocean Strategy

- The concept of *blue ocean strategy* was introduced in a book of the same name written by W. Chan Kim and Renée Mauborgne. These authors argued that dual advantage is not only possible, but it's much more prevalent than Porter believed. Kim and Mauborgne claimed that true innovators are able to break the trade-off between low cost and differentiation and create a new value proposition that allows them to deliver both.

- As an example, the authors point to Cirque du Soleil, which is a hybrid of a circus and a Broadway show. The show charges a premium price, yet the authors argue that it has lower costs than a typical circus.

- Southwest Airlines is offered as another example of a blue ocean company, but it doesn't charge premium prices. Southwest is a low-cost player that's different but not differentiated in the sense that it enjoys higher willingness to pay than many of its rivals.

- According to Kim and Mauborgne, a blue ocean firm is created by turning around the strengths and weaknesses of a typical firm in an industry. Can a new firm be great at things that typical firms in the industry aren't doing well? And can a new firm sacrifice or cut down on things in which other firms invest?

- Cirque du Soleil, for example, invests in choreography and the composition of beautiful music—things that a typical circus doesn't have—but it doesn't have animals or star performers. By making

those kinds of choices, a new firm can flip the industry on its head and create a different company, one that doesn't have direct competitors.

- Kim and Mauborgne offer what they call the four actions framework to help people think about how they might redefine an industry and come up with a strategy that sets them apart from many competitors. The key questions to ask here are: (1) What can you eliminate that others are doing? (2) What can you reduce? (3) What can you create? (4) What can you enhance?

- Interestingly, this model actually seems to have much in common with Porter's work, particularly with regard to the idea of trade-offs. By eschewing certain activities that are commonplace in an industry, firms can create a distinctive position that's hard to imitate.

Homogenization

- In benchmarking, a firm typically looks for things that it's doing less effectively than the competition and tries to catch up. Unfortunately, benchmarking can lead to the homogenization of strategies. This is not to say that you shouldn't study the competition, but you may want to amplify what you do differently rather than just trying to catch up.

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Today, we often see many different brands, flavors, and sizes of certain products, but in the end, the products are just commodities; they're not truly differentiated.

- Youngme Moon, a marketing professor at Harvard Business School, has noted the phenomenon of convergence in many industries, with rivals becoming increasingly alike. In retail stores, Moon sees what she calls heterogeneous homogenizing. In other words, there is diversity on the surface but homogeneity underneath. Companies are spending a great deal of money to create many varieties of the same basic products.

- As we've seen, however, strategy rests on unique activities. And to create a sustainable strategic position, you must make trade-offs. Without making those trade-offs, your ideas can be imitated, and you won't be able to sustain your advantage.

Suggested Reading

Ager and Roberto, "Trader Joe's."

Kim and Mauborgne, *Blue Ocean Strategy*.

Moon, *Different*.

Porter, "What Is Strategy?"

Questions to Consider

1. What is the value of making a series of trade-offs as you formulate a competitive strategy?

2. Why do firms have such a hard time imitating a company that has made a number of trade-offs?

3. Why is it so difficult to achieve dual advantage?

First Movers versus Fast Followers

Lecture 5

First-mover advantage is the competitive advantage established by virtue of the fact that a company has entered a market first and established a position. And it's true that first movers sometimes do achieve tremendous advantage; consider Gillette in razors or Coca-Cola in carbonated soft drinks. But we also have plenty of examples of first movers that did not succeed or were completely eliminated from the market. Before Facebook, for example, there was a social media company called Friendster, and before Google, there was Netscape. In this lecture, we'll challenge the commonly held view that being first is crucial.

Sources of First-Mover Advantage

- First movers gain advantage from four major sources: economies of scale, economies of scope, network effects, and learning effects.

- Economies of scale exist in a business when the costs per unit to produce and distribute a good fall as the business produces more units of the good in any given time period. In other words, the larger you are, the more your costs per unit come down. Scale economies are pronounced in such businesses as Toyota, Bank of America, and FedEx. The higher the volume for any business with high fixed costs, the greater the degree to which those fixed costs can be amortized over many units, bringing the cost per unit down.

- Learning effects also bring about falling costs per unit. In this case, however, the lower costs are not the result of more units being produced in a given time; instead, they're attributed to efficiencies learned from producing the good over an extended period.

- Another source of first-mover advantage is network effect, which has less to do with cost and more to do with perceived value on the part of the user. A network effect is seen when the value per user rises as the total number of users rises. Network effects are

in play in such businesses as eBay, LinkedIn, Google, eHarmony, and Amazon. For example, eBay, has value for users because many other buyers and sellers can be found on the site.

- ○ Presumably, the first mover can gather many users and, thus, increase its own value to each user. That creates an advantage over the upstart who comes in with no users and has very little value to offer.

- ○ Many Internet firms that are in businesses where network effects exist have pursued the so-called get-big-fast strategy. The first order of business here is to build a network effect as a defense against others who might come in later and try to compete; it's only after they've built the network that these firms figure out how to make money. In fact, this has been a powerful phenomenon for such firms as Facebook and LinkedIn.

- ○ In markets with network effects, typically, there are high switching costs for users, which results in a lock-in effect. Users are, in effect, stuck with a particular good, service, or platform. From the perspective of the user, that may not be ideal. But from the perspective of a company offering a product or service, switching costs are wonderful.

- ○ In some markets with strong network effects, not only is there a first-mover advantage, but the first mover can also come to be the dominant technology or firm—the so-called standard in the market. This is true of Microsoft Windows, which has 90% of the market share in the operating system market. Keep in mind, though, that with certain products or services, there may also be high demand for variety on the part of the customer. This is the case, for example, with video games, which have a wide array of customers.

Countering Conventional Wisdom

- The speed at which a given market or technology evolves can have a significant bearing on whether a dominant player will emerge with enduring first-mover advantage.

    - One product for which there is fairly slow evolution of both technology and the market is Scotch tape. 3M created this product in a very slow-moving space and has been able to achieve enduring first-mover advantage.

    - But in the personal computer business, where we've seen rapid technological obsolescence and a great deal of dynamic change over time, it's much more difficult to establish and maintain a first-mover advantage.

- Another reason that first movers don't always win is that there may be high costs involved in blazing a new technological trail. Such costs are known as *pioneering costs*. In particular, educating consumers about an entirely new product category may be expensive, and a great deal of change may take place early in a technology's existence. *Fast followers*—those who come in after a first mover—may be able to take advantage of the fact that you've blazed the trail, then move quickly to supersede you.

- Those who move first may also have to make certain commitments that can become rigid and difficult to change. First movers who have had initial success may become complacent or experience organizational inertia and may not be able to change as the market begins to evolve.

- In addition, first movers may fall into the *sunk cost trap*. They invest heavily in a particular technology or way of doing business, and even if they start to get negative feedback, they can't cut their losses and shift strategy. They become over-committed to an initial course of action and fail to adapt as markets evolve.

- Business researcher Greg Carpenter has noted that in many cases, pioneers in a field are not very well funded. They create a competitive game, but they're unable to dominate it because their resources are simply too limited.

- Despite the disadvantages first movers face, there are a number of situations in which pioneering may be the right strategy: if the expected life of a product category is very short, if the value of the product is highly subjective or intangible, if brand is important, and if the cost of imitation is high.

Economies of Scale

- Although we've said that economies of scale represent a source of first-mover advantage, managers often grossly overestimate the importance of this factor.

- Costs per unit certainly fall over time as volume increases in many businesses, but at some point, that curve begins to rise again. In other words, the costs per unit eventually start to rise again as a company gets too big, complex, and bureaucratic. Organizations grow to a point at which some inefficiency begins to be built in, and smaller firms then gain the advantage.

- In many cases, firms believe that bigger is better because that has been true in the past. For example, scale was a tremendous advantage for General Motors for much of the 20th century. But eventually, the firm's size became a liability. GM became vulnerable, because it wasn't as flexible and nimble as other firms.

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Large companies may sometimes overestimate the importance of economies of scale and fail to realize the disadvantages they have relative to start-ups and entrepreneurs.

Learning Curves

- Learning curves can also be a significant source of first-mover advantage, but in some situations, firms may be unable to hold onto their learning or protect their intellectual property. The result is what scholars call *spillover effects*—when the learning a firm has achieved through experience spills out beyond the boundaries of the firm. A second mover can capture those spillovers and can learn from the first mover's mistakes.

- This issue is particularly problematic in economies without strong intellectual property protection, such as China. It's also challenging in situations where labor is very mobile and the knowledge that's being created cannot be easily protected through patents; such was the situation in Silicon Valley, for example.

Network Effects

- It seems that if network effects exist, it would always make sense for a firm to be first and get big fast. But think about social media. If network effects are so crucial in that business, then how is that Facebook was able to supplant early players, such as Friendster and Myspace?

- Misiek Piskorski is a scholar who studied social media platforms, and he concluded that for some certain networks, customers actually prefer a non-crowded space. They want more users—there's value as others use the site—but if too many people use the site, the value starts to turn negative.

- The example Piskorski gives is eHarmony. Users want to be on a dating platform where there is a wide variety of potential partners, but they don't want too many other people on the platform because that eventually causes competition.

- Felix Oberholzer-Gee at Harvard has also looked at possible downsides to the network effect. In social media, the early company Friendster pursued a get-big-fast strategy, trying to get customers in both Asia and North America.

- ○ But the Asian users generally weren't interested in interacting with American users and vice versa. Thus, spending money to build two giant sets of individuals on the network on two different continents didn't actually add a lot of value.

- ○ Friendster might have done better if it had focused on building the network in only one region, rather than trying to expend its resources to get big fast across two regions. That waste of resources made the company vulnerable to others—specifically, Facebook—which built a better platform with a more focused strategy.

- ○ Not only did Facebook focus on only one region, but it also focused initially on only one customer segment—college students. This focus created network effects but in a bounded way.

Diminishing First-Mover Advantage?

- Might there be less first-mover advantage today than there was several decades ago in business? As we've seen, incumbents seem to get toppled much more readily, and firms face much shorter periods of time during which they're able to achieve advantage and hold onto it.

- Some scholars have looked at platforms where users can sign on across multiple platforms and move their contacts easily. They have one profile that they can use on multiple networks and can move with their friends en masse from one platform to another. In these situations, users are not as locked in as they were previously, which means that first movers have less of an advantage.

- One strategy for dealing with situations where network effects exist has been described as the *freemium business model*. Here, a firm might give away a product for free but also have a premium offering that requirements payment. This model is used by LinkedIn, which

has two levels of membership. The model makes sense for a firm that's trying to build a network quickly and if there are low marginal costs for adding new users.

- It's important to think carefully about the pluses and minuses of pioneering versus being a fast follower. Understand the sources of first-mover advantage and the limitations of those advantages. As an entrant or a follower, exploit the weaknesses in a pioneer's first-mover status. In short, don't buy the conventional wisdom: Being first is not always as advantageous as we think it is.

Suggested Reading

Anderson, *Free*.

Coughlan, "Leader's (Dis)Advantage."

Shankar and Carpenter, "Late Mover Strategy."

Shapiro and Varian. *Information Rules*.

Suarez and Lanzolla, "The Half-Truth of First Mover Advantage."

Questions to Consider

1. What are the pros and cons of being the first mover?

2. Why do first movers not always succeed, even when learning curves and network effects exist?

3. What are some examples of firms that have used network effects to achieve competitive advantage?

When Netflix Met Blockbuster

Lecture 6

In this lecture, we'll go back to 1999 and take a look at the retail chain Blockbuster, which sold and rented videos. At the time, Blockbuster's mainstream customers were 30- to 45-year-old soccer moms, living in the suburbs with their families and looking to rent new movie releases on VHS tapes. In the same year, Netflix began offering its service, which allowed people to rent movies through the mail by subscription. Its mainstream customers were 18- to 29-year-old males who watched DVDs rather than tapes and were interested in cult classics and independent films. In this lecture, we'll look at how Blockbuster reacted to the disruptive innovation in the industry presented by Netflix.

Disruptive versus Incremental Innovation

- In 1999, Blockbuster's market research probably revealed that its customers wanted more copies of hit movies to be available in stores. In response, the company began to guarantee just that—that its stores would have new releases on hand to rent. The "new release" section of the stores changed from a small area to an entire wall and, later, to the entire perimeter of the store.

- However, the potential Netflix customer—the young men who liked cult classics—were dissatisfied with this change. There was no room on the shelves for old movies because new releases had crowded them out. Further, these customers disliked late fees because they didn't have much money and because they liked to keep movies longer and watch them multiple times.

- In making the change, Blockbuster pursued *incremental innovation*. The company conducted focus groups and surveys among its mainstream customers and, in response to their suggestions, offered a small improvement in its service. But Netflix presented a *disruptive innovation*—a fundamentally different product, service, or business model—that undermined Blockbuster's competitive advantage.

- As we've said, there are three main external threats to competitive advantage: imitation, substitution, and holdup. In many ways, substitution is the most serious of these, and that's the threat that Netflix presented. Substitution is often hard to foresee and, perhaps, even harder to respond to.

- Many years ago, the economist Joseph Schumpeter wrote about the need to look beyond your direct rivals when thinking about the principal threat to your competitive advantage. He said that attention is often focused exclusively on competition within a rigid pattern of invariant conditions, methods of production, and forms of industrial organization. But in reality, that kind of competition is not as threatening as the competition from a new commodity, new technology, or new type of organization.

- Earlier in his academic career, Harvard Business School professor Clay Christensen traced the evolution of the disk drive industry from 1976 through 1992, watching as a series of technological innovations came to market and observing what happened to the players in that market.
    - From a technological perspective, the physical size of the disk drive shrank dramatically during that time. Moreover, the cost per megabyte of storage dropped substantially. In this situation, Christensen observed that the incumbent leaders in one generation of technology often were not able to maintain their leadership in the next technological generation.

    - Christensen argued that the incumbent players were intent on pursuing incremental innovation—minor improvements to the attributes that mainstream customers valued. In contrast, disruptive innovators introduced a different package of attributes from the ones that mainstream customers typically valued. Indeed, disruptive innovators often performed significantly worse on certain attributes that mainstream customers valued highly, but their performance trajectory was steep for the disruptive innovations.

- In our example, Netflix wasn't focused on such attributes as in-store experience or availability of new releases. In fact, Netflix performed significantly worse on some of these attributes. But Netflix was focused on renting older movies, and it came up with a new way of doing business for that purpose. Initially, Netflix didn't perform well, but the company improved at a rapid rate.

Challenges in the Face of Disruption

- In the face of disruptive innovation, incumbent firms often struggle a great deal. According to Christensen and his coauthor, Joseph Bower, the sources of incumbents' problems are traditional market research and traditional resource allocation processes.

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As Blockbuster learned, conducting market research with typical customers tends to result in incremental innovation; it doesn't help you foresee disruptive innovation.

- Of course, traditional market research focuses on gathering feedback from customers. But customers tend to think in terms of incremental improvement—minor adjustments a firm might make to increase customer satisfaction. Customers don't think in terms of totally new ways of doing business.

- In addition, incumbent firms tend to have rigorous financial criteria for allocating their investment dollars. If someone has a new idea, the firm looks to cost-benefit analysis or return-on-investment figures to determine whether the idea makes economic sense. With an idea that's completely new or involves cutting-edge technology, it's difficult to come up with precise financial models. Large firms also often fear that a new product or service will cannibalize an existing one.

- Another reason that incumbent firms struggle so much with disruptive innovation is *mental lock-in*. Such firms get stuck in a particular mental model of how to make money in their markets and don't consider alternatives that may be introduced by disruptive innovations.
    - For example, Polaroid was built on a deeply imbedded razors-and-blades business model: Sell cameras to people at relatively low cost, and they will buy film for many years to come. In fact, Polaroid made most of its money on film.

    - Many people believe that Polaroid simply failed to recognize the revolution in digital photography, but that's not the case. Substantial research and development activity in digital technology took place at Polaroid, but senior executives were strongly resistant to giving this new technology the resources needed to go to market because they were wedded to the old business model.

The Long Tail

- The *long tail* is an idea put forth by Chris Anderson, the former editor of *Wired* magazine. Anderson looked at the largest brick-and-mortar music retailer in the United States, Walmart, which at the time of his study, carried about 4,500 unique CD titles, or about 55,000 songs.

- Most of the activity in the music section of Walmart stores centered on the hits. The top 200 albums—about 5% of the albums in the section—accounted for 90% of Walmart's music sales at any given point in time. In this, Walmart's music business exhibited the usual pattern found in hit-driven businesses (books, movies, and music) before the Internet.

- But Anderson noticed something different when he looked at some of the emerging technologies of entertainment, such as Rhapsody, a digital music service. Rhapsody carried more than 1.5 million songs, and a big chunk of its sales also came from hit songs. But Rhapsody also reported that songs ranked as low as 900,000 on its popularity charts were streamed at least once per quarter.

- Anderson noticed the same phenomenon in other new economy firms: 21% of Netflix's revenue was generated from movies not available at Blockbuster; 40% of Rhapsody's revenue was generated from music not available at Walmart; and 25% of Amazon's book business was generated from books not available in brick-and-mortar stores. The long tail is the idea that a great deal of revenue can be generated from products that are low in popularity.

- According to Anderson, traditional entertainment retailers made all their money from the hits. Hybrid retailers, selling physical goods through catalogs or online sites, could make money from many more items because they could stock more of those items in a distribution center than in a physical store. And purely digital retailers could make money on an even wider array of products. No matter how low in popularity an item is, the cost to add it to a digital library is so low that a digital retailer can make virtually any song or movie available even if there is only one customer who wants it.

- Anderson also noted that social networking, customer reviews, playlists, blogs, and other forms of social media drive demand for these niche products, rather than mass marketing. Beyond that, digital retailers can collect information about customers and build sophisticated algorithms to create customized recommendations for them. Netflix, for example, built a huge customer database, and the predictive power of its algorithms was quite high. When Blockbuster tried to catch up, it wasn't able to capitalize on the same network effect.

Reacting to Disruptive Innovation

- In his work on disruptive innovation, Clay Christensen argued that incumbent firms must create a separate unit or subsidiary to react to an upstart entry and wall this unit off from the mainstream business. This separation is necessary because without it, the mainstream business will squash the innovation in an effort to protect its profit margins.

- Some have critiqued Christensen's theory of disruptive innovation, and in fact, it may be an overused concept. It's a good descriptive tool but not necessarily a good predictive one. In addition, Christensen focuses on the idea of incumbent firms missing a disruptive threat, but he doesn't address the misguided investments firms can make when they misperceive a threat. Creating a new unit to cope with a threat may not always be wise.

- It's also important to consider the competitive advantage that comes from an integrated system of activities. If a firm creates a separate unit to go after a new idea, will it still have an integrated system of activities, or will the firm become disjointed?

Suggested Reading

Anderson, *The Long Tail*.

Christensen, *The Innovator's Dilemma*.

Lepore, "The Disruption Machine."

Questions to Consider

1. How do resource allocation processes in large organizations stifle radical innovation?

2. How have many innovators capitalized on the long-tail phenomenon to build successful businesses?

3. Why has the theory of disruptive innovation become so widely embraced and, perhaps, misused at times?

Anticipating Your Rival's Response

Lecture 7

In this lecture, we'll try to understand competitive dynamics in more detail. As we'll see, successful firms are able to put themselves in the shoes of their rivals, anticipate how those competitors will react, and use that information to help plot more effective strategies. In particular, we'll look at three well-known historical examples of competitive dynamics in the business world: the story of NutraSweet and its reaction to a new entrant in the market for artificial sweeteners, the case of the upstart Irish airline Ryanair that competed against two dominant incumbent players, and Blockbuster's reaction to Netflix.

Analyzing Competitors

- Analyzing competitors is a multifaceted task that starts with looking at their past and current strategies, understanding what they're trying to accomplish, and identifying how they're trying to position themselves in the marketplace. It also involves trying to understand their goals. What specific financial targets and market-share goals are they trying to achieve? How are they trying to advance the objectives of their shareholders, satisfy their customers more effectively, and keep their employees motivated and engaged?

- It's also important to understand your competitors' capabilities and weaknesses. What is world class about their production, distribution, and research and development, and where do they lag behind?

- Perhaps most importantly, you need to try to get inside the heads of the executives in a rival firm. What industries are they from, what companies did they work for in the past, and how might those experiences shape their decision making? Where have they succeeded in the past, and where have they failed? Is there a certain formula that has worked for them in the past that they are likely to go to again in hopes of achieving another success?

- Anticipating a competitor's actions and potential responses to your actions means understanding four factors:
    - First, you must understand the economic and financial incentives of your competitors—the costs and benefits of a particular action.

    - Second, you must look at the competitor's noneconomic motives, such as making itself a more attractive workplace or, perhaps, forsaking profits in the short term to achieve a more dominant position in the marketplace.

    - The third factor to understand is the biases that may affect your rival's behavior. For example, is your competitor falling into the sunk-cost trap, that is, escalating its commitment to a course of action even if that action is failing?

    - Finally, you need to understand the broader context in which your rival operates. What political and historical factors may affect the rival firm's responses or shape its actions?

Economic Motives

- To understand a rival's economic motives, a simple application of game theory may be helpful. In game theory, one player tries to predict what an opponent might do in various circumstances and bases his or her strategy on that prediction.

- Many researchers have applied game theory to the scenario of an entrepreneur moving into a new market and confronting an incumbent player. Here, the entrant faces a simple choice: whether to move into the market or not. The incumbent also faces a choice: whether to respond aggressively or to accommodate, perhaps even relinquishing a small amount of market share in hopes of maintaining its current pricing, marketing spend, and so on.

- Applying game theory, a new player coming into a market might anticipate that the incumbent would be reluctant to fight a price war, which would mean sacrificing profit by cutting revenue

dramatically and, perhaps, saving only a small amount of market share. The better course for the incumbent would be to give up a small piece of the market in exchange for maintaining its current prices. In this situation, the new entrant might conclude that entering the market is a good move. In contrast, if the entrant believes that the incumbent will retaliate aggressively, then entering the market might not be affordable.

- The idea here is to look forward and reason back. Game theorists call this type of thinking *backward induction*. Ask yourself what your rivals will do in the future based on your actions now. From the answer to that question, you decide what to do today.

- Game theory can be helpful for thinking about the potential responses of competitors to your choices, but it's limited in some ways. The real world is different than the realm of game theory because the actors may not be completely rational—they may not care only about maximizing economic profits.

Netflix and Blockbuster

- In 1999, Netflix entered the movie rental market, confronting the incumbent, Blockbuster. In response, Blockbuster had a choice: whether to fight the new player or accommodate.

- Recall that Netflix came into the market with a different pricing model than Blockbuster. Netflix charged a monthly subscription fee, rather than per movie, and it didn't charge late fees. Thus, one important decision that Blockbuster had to make early on was whether to cut its late fees, which generated at least $300 million per year for the company.
    - Keep in mind that in its first few years, Netflix had only a few hundred thousand subscribers, while Blockbuster had millions of customers.

- For Blockbuster, cutting late fees would destroy the entire profitability of the firm, while saving only a tiny slice of market share. In this situation, Blockbuster chose to accommodate, keeping its late fees and preserving its profitability, while ceding some customers to Netflix.

- In making this decision, Blockbuster's projection was that Netflix was a niche player that would never become mainstream. Of course, Blockbuster was wrong. The company eventually had to cut late fees, but it took years to reach that decision.

Rynair and British Airways

- In the 1980s, when Ryanair entered the European airline industry, it probably believed that British Airways would not cut its prices because doing so would result in a significant hit to the incumbent's profits. At the time, British Airways charged IR£166 for the London-Dublin ticket, while Ryanair planned to charge IR£98. A price war would mean a substantial drop in revenue and profitability for the incumbent.

- Keep in mind, too, that the slice of the market Ryanair sought was tiny. In fact, the company originally had only a few small planes and planned to make just four round trips per day between London and Dublin.

- British Airways faced the choice of destroying its profitability by cutting prices dramatically for that route or giving a few seats to Ryanair and maintaining its pricing. But British Airways also had to think about the entrant's intentions: Will Rynair grow? Will it add capacity, and if so, what effect will that have on the market? Further, if British Airways accommodated Ryanair, would other new players try to come into the industry?

Lessons for Incumbents and Entrants

- Incumbents can learn a number of important lessons from such situations.
    - First, you don't want to ruin the whole market just to save a small slice. But it's also true that you may be able to identify and focus on the customers who are most likely to defect to the new entry. In that situation, you could cut prices or market aggressively to one segment of customers but maintain higher prices for others. Such a strategy would allow you to attack without destroying your own profitability.

    - You should also consider the signals you send by your responses to new entrants. Perhaps fighting aggressively will deter other entrepreneurs from entering your segment.

    - Finally, you should think about how fast entrants may grow. Is this upstart a niche player, or is it focused on taking over the market?

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A smart way to analyze the competition is to ask your management team to role-play how a competitor might respond to your firm's actions.

- Potential entrants should also think about a range of factors that might prompt incumbents to make aggressive moves.
    - Is this a slow-growth market? If so, the incumbent might fight hard to preserve its customers.

    - Is this a commodity product? If a product is not highly differentiated, an incumbent might resort to price as its only competitive weapon.

    - Does the incumbent have high fixed costs relative to marginal costs? If so, it might respond aggressively simply to keep its capacity utilization high to cover fixed costs.

    - What kind of resources does the incumbent have to wage a battle?

    - How has the incumbent reacted when other companies have entered the market?

    - Can the incumbent target its fight? Will it have to cut prices across the board, or can it lower prices only for a segment of customers who are most likely to defect?

NutraSweet and Holland Sweetener

- In the 1980s, NutraSweet was the dominant player in the artificial sweetener market, but the company's patents were about to expire, and others were looking to enter the market.

- A potential new entrant, Holland Sweetener, made the mistake of not understanding NutraSweet's powerful cost advantage. In other words, the artificial sweetener industry was highly influenced by economies of scale and a substantial learning curve, and NutraSweet had the advantage in these factors. For Holland Sweetener, that meant that NutraSweet could fight aggressively, cutting its prices significantly while still making money.

- Holland Sweetener also failed to apply game theory to understand NutraSweet's relationship with its two largest customers, Coca-Cola and Pepsi.
    - Holland figured that Coke and Pepsi wouldn't want to be entirely dependent on NutraSweet and would shift some of their volume over to a new entrant in the market, especially if they were offered an attractive price.
    - But Coke and Pepsi were caught in game theory's classic prisoner's dilemma: It would have been in each company's interest to switch some volume and get a better price from Holland, but neither wanted to move first. Each company believed that if it changed an ingredient, its rival would argue to customers that the taste of the product had changed.
    - For this reason, NutraSweet was able to retain its customers, and Holland never made money in the artificial sweetener market.

Suggested Reading

Coughlan, Freier, and Kaiho, "Competitor Analysis."

Dixit and Nalebuff, *The Art of Strategy*.

Rivkin, "Dogfight over Europe."

Questions to Consider

1. Why is game theory useful in conducting competitor analysis?

2. Why do we have to go beyond thinking about the short-term economic motives of our rivals?

3. Why might incumbent firms retaliate aggressively against a new entrant, even at a significant short-term financial cost?

Why Did Disney Buy Pixar?

Lecture 8

The Walt Disney Company competes in a number of businesses, including theme parks, a film studio, cable television channels, hotels, retail stores, consumer products, and more. Disney is a multi–business unit corporation, and each of its business units competes in a different product market. Thus far, we've been discussing strategy on the business unit level. How does a company gain advantage over its rivals in a particular product market? In this lecture, however, we'll turn to corporate strategy, asking the question: In what markets does a company choose to compete? With a multi–business unit corporation, such as the Walt Disney Company, why has the firm chosen to build a particular portfolio of businesses?

Horizontal and Vertical Integration

- With horizontal integration, a company chooses to compete in multiple product markets in the hopes of achieving some integration or synergy across those business. Horizontal integration can be divided into two categories: related diversification and unrelated diversification.
    - Of course, *related diversification* applies when a company appears to be competing in related product markets, where there are apparent synergistic possibilities. Examples include Disney and Procter & Gamble.

    - *Unrelated diversification* refers to a situation in which a company appears to be competing in markets that don't have much to do with one another. Examples here include General Electric and the Virgin Group.

- With vertical integration, the company isn't competing in multiple product markets. Instead, it focuses on one particular product market and competes along multiple links of the supply chain. Vertical integration can also be divided into two types: forward integration and backward integration.

- ○ *Backward integration* refers to a company that produces its own components or raw materials.

- ○ *Forward integration* refers to a company that operates its own distribution or retail store network.

- In evaluating corporate strategy, we ask two fundamental questions about each of the businesses that are part of a firm's portfolio: (1) Is each business better off as part of the corporation than it would be by itself? (2) Does each business unit within the corporation outperform comparable focused companies—those that compete in only one product market?

Related Diversification

- Related diversification is focused on the idea of synergy, or what economists call *scope economies*. The related diversification strategy tries to achieve scope economies among businesses competing in similar product markets. Put another way, with a related diversification strategy, the firm tries to share resources or capabilities across multiple businesses, whether those resources are distribution channels, sales forces, R&D facilities, or factories. In Disney's case, the company shares its characters across multiple businesses, leveraging them to enhance the value of its television shows, theme parks, and consumer products.

- Put another way, economies of scope exist when each business unit enjoys either a stronger willingness to pay or lower costs because of its cooperation with sister units. The related diversification

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Disney believes that its theme parks are somehow more valuable as part of the Disney family than they would be as an independent company.

strategy is all about strengthening the competitive advantage of each of the business units, making it better off than it would be on its own.

- Disney's theme parks, for example, seem to enjoy higher willingness to pay than competing theme parks largely because Disney's characters are incorporated into the theme parks in multiple ways.

Specialized versus Fungible Resources

- Disney is a powerful example of a company that has leveraged a set of resources and capabilities into a number of different businesses. In particular, Disney's characters are valuable resources because they are highly durable and difficult to imitate. How can a firm leverage such valuable resources across multiple business units? To answer that question, we need to think about specialized versus fungible (general) resources.

- Examples of highly fungible resources or capabilities include brand management expertise, innovation, and risk management—fairly generic capabilities that could apply widely across a range of businesses. A highly specialized capability might be a patented product formula or specific engineering expertise in a narrow discipline.

- A fungible capability can be transferred easily across lines of business. But if it's too general, it won't provide substantial competitive advantage. Highly specialized capabilities can convey powerful competitive advantage, but they may not be as widely applicable.

- In the 1980s, when Michael Eisner arrived at Disney, the company's core capabilities revolved around animated character development and deployment—highly specialized capabilities that constrained growth in some ways. But Eisner redefined Disney's core capabilities more broadly—as creativity management. This definition enabled him to justify the move into a broader range of businesses.

  - Interestingly, in Eisner's first decade at Disney, when he was focused on leveraging the characters, the company did incredibly well. But as he stretched the definition of what Disney was good at—moving farther away from its core business into sports teams, films for adults, and so on—performance started to suffer.

  - Bob Iger, the chief executive who took over from Eisner, appears to have returned to the formula of leveraging characters and has had great success financially.

Transaction Costs

- Just looking at synergy alone is not enough in thinking about whether multiple businesses should be under one roof. It's also important to ask whether the businesses should be merged or can act as partners.

- There is some cost to bringing two companies together under one roof—costs related to additional bureaucracy, costs of going through a merger, and so on. In some cases, it may be wiser to keep the companies independent but cooperate and achieve economies of scope. Consider this issue is terms of Disney's hotel and consumer products businesses.
  - Disney owns many hotels near its theme parks, but it outsources production of its consumer products, such as toys and games. Consumer products are synergistic with the rest of the Disney family, but the company has chosen not to manufacture those products in house. What's the difference between the hotel business and consumer products?

  - One major difference is that the hotel business offers more of an indefinable experience that's created by Disney, while consumer products lend themselves to a clear design that can be communicated to an outside manufacturer.

- This issue relates to a question asked by Novel Prize winner Ronald Coase in a paper called “The Nature of the Firm”: Why do firms exist? If markets are such a great way to coordinate economic activity, why is not all activity conducted through the marketplace with small firms run by entrepreneurs? Why do we need large organizations?
    - Coase refined the questions as follows: Should economic activity be coordinated by the market mechanism or by intra-firm organizational structures and processes? In other words, should you contract with an outside supplier to make components, or should you build and run your own factory?

    - Coase’s answer was that it’s necessary to look at the transaction costs associated with organizing certain economic activities. For a company deciding whether to contract with an outside manufacturer or handle its own manufacturing, the question becomes: Under which arrangement will the transaction costs be lower?

    - For Disney, it would be difficult to train personnel from an outside hotel chain to create the guest experience that Disney seeks; thus, the firm owns its own hotels and monitors the interaction between employees and guests closely. But consumer products can be monitored from afar, which means that the company can outsource manufacturing to get the best price.

- Three factors drive transaction costs: uncertainty, frequency, and asset specificity.
    - Market coordination becomes very difficult and costly when the potential arises for opportunistic behavior, and such potential exists when economic actors invest heavily in transaction-specific assets—in other words, when factors of production are highly specific to the other party.

- Imagine an oil refinery that has only one way to pump its oil to customers—from a pipeline attached to the refinery. The pipeline has only one use—to pump the oil from that particular refinery. Could the refinery and the pipeline be independent companies and contract with each other? The answer is no.

- Each asset is completely specific to its partner asset; therefore, the two are totally dependent on each other. Problems could arise if one partner reneged on the contract or tried to get a better price from the other. Their codependence makes it difficult for them to operate peacefully through the marketplace; for this reason, the two should operate as one firm.

- Of course, the choice is never simply to own or to contract with an outside supplier. There is a spectrum of choices in between those two options, such as a joint venture, strategic alliance, franchise or licensing arrangement, and so on. Two companies that have the ability to cooperate and achieve synergy may do so as independent companies, through some kind of alliance, or through a merger.

- To close this lecture, let's think about asset specificity and codependence in the context of Disney and its acquisition of Pixar.
    - When Pixar was making its first feature film, *Toy Story*, the firm approached Disney to act as distributor for the movie. Disney agreed under the condition that it would retain the characters that Pixar developed and be able to use them in sequels, in the theme parks, and so on, even if Pixar eventually went on to work with another studio.

    - A decade later, Pixar had achieved remarkable success, but Disney Animation was struggling. Pixar threatened to go to another studio but ultimately didn't because of the earlier agreement that Disney would retain the characters.

- In the end, Disney acquired Pixar because the two firms had become codependent. They couldn’t work together through the market; to achieve synergy, they had to come together in a merger. Today, the Pixar characters are leveraged in the same way that other Disney characters are across a range of businesses. Pixar was more valuable as part of the Disney family because Disney could fully exploit the value of those characters in a way that few other firms could do.

Suggested Reading

Coase, “The Nature of the Firm.”

Collis and Montgomery, *Corporate Strategy*.

Williamson, *Markets and Hierarchies*.

Questions to Consider

1. Why do firms diversify, putting multiple business units under one corporate parent?

2. What alternatives exist to horizontal and vertical integration?

3. Why must we consider transaction costs when determining the appropriate corporate strategy?

The Diversification Discount

Lecture 9

Consider two historical corporations that used to be very successful: Fortune Brands and Sara Lee. Fortune Brands was a large, diversified firm that competed in three segments: golf, liquor, and home hardware. In addition to producing baked goods, Sara Lee owned a chain of supermarkets, the Coach handbag company, Jimmy Dean meats, and other businesses. As we saw in the last lecture, Disney is a related diversified firm seeking to pursue synergies across product markets. In contrast, Fortune Brands and Sara Lee are two classic examples of unrelated diversification. In this lecture, we'll look at why these firms assembled the portfolios they did and why they later sold off these divisions and became much narrower in focus.

Analyzing Diversified Firms

- When looking at a diversified firm, analysts and investors compare its market value to its *breakup value*—that is, the amount each of the firm's divisions would be worth independently. Analysts try to learn whether the sum of those amounts would be more or less than the value of the whole company.

- A *diversification discount* results when the whole is worth less than the proposed sum of the parts. Unfortunately for many diversified firms, particularly unrelated diversifiers in the United States, it's often the case that the whole is worth less than parts, which is why we've seen many corporate breakups in the last few years.

- Research from academics has also demonstrated that firms that focus on one product market tend to do well in the United States. Studies have shown that increases in focus tend to be followed by stock price increases, and decreases in focus are often followed by stock price decreases. Further, both spinoffs and their original parent companies tend to outperform the overall stock market after the separation of the two.

- All this financial evidence has proven to be a powerful rationale for companies to slim down and for fewer companies to pursue a strategy of unrelated diversification. However, it's also important to look at each company individually to understand its strategy. In some cases, a company's management may argue that the firm is pursuing a related diversification strategy, while investors and analysts may think that its business units are unrelated.

Risks of Unrelated Diversification

- There are four invalid reasons for diversification.
    - The first of these is to diversify risk. Management may plan to have some businesses in a firm's portfolio that tend to do well in a strong economy and others that are counter-cyclical. When one of these businesses is doing well, the idea is that it would offset others that are experiencing difficulties. But diversifying risk is an invalid reason for a company to pursue a diversification strategy.

    - A second invalid reason for diversification is known as *cross-subsidization*—that is, having a portfolio of seemingly unrelated businesses at different stages of the business life cycle. Businesses using this strategy are taking the cash that's being generated by profitable but mature businesses and using it to fund growth in newer, high-growth industries.

    - Businesses also sometimes pursue unrelated diversification when they are looking for revenue and profit growth because of problems in the core business.

    - Finally, some companies look to unrelated diversification in an effort to manipulate the stock markets. They try to enhance the valuation of a business that is, perhaps, mature and not growing by acquiring a newer, higher-growth business.

- As individuals, we know it makes good sense to diversify our investment portfolios, but individuals can diversify much more effectively and inexpensively than companies can. The external

capital market does a much better job of moving resources around and valuing opportunities than the internal market. In a sense, we can say—and research confirms—that a manager at the top of a corporation is not as smart as the crowd—the entire external market.

- Cross-subsidization—taking money from mature businesses and funding new opportunities—came from a concept introduced by the Boston Consulting Group many years ago, the so-called BCG Matrix. The basic matrix is shown below.

	Low Market Share	High Market Share
Slow Growth	Dog	Cash Cow
Fast Growth	Question Mark	Star

  - BCG argued that an unrelated corporation could effectively classify its business units by looking at two basic measures: What kind of market share does the particular business have, high or low? And how fast is the particular industry growing?

  - In the matrix, a unit that is in a slow-moving industry and has low market share is a dog. A unit in a slow-moving industry with high market share is a cash cow; it generates a great deal of cash and doesn't have many opportunities to reinvest the money in the business. A unit with a low share in a high-growth industry is a question mark; it may or may not turn out to be profitable. Finally, a unit with a high share in a high-growth industry is a star.

  - The idea of the matrix was to divest the dogs and milk the cash cows. Take the excess cash from slow-moving industries and invest in the question marks, even if they were unrelated to the mainstream business.

  - Again, this strategy presumes that managers inside the firm can allocate resources better than the external market—that they know where the best new opportunity is and they can

beat the market, but this is very difficult to do. The wiser course is often to give the excess cash back to the investors and allow them to find the next opportunity. Let the question marks get their funding from venture capitalists, angel investors, or private equity firms rather than large, complex, and mature corporations.

Governance Economies

- A company is pursuing unrelated diversification when it is operating various businesses independently. Instead of trying to add value to each of its businesses through the realization of synergies—as we saw with related diversification—the idea here is to add value by using a common management system across all the businesses. The premise is that by having a single company controlling operations and by transferring knowledge and best practices among the businesses, all the businesses are managed better together than they could be managed on their own—and they achieve governance economies.

- In this strategy, it's purely management skill that is being leveraged across businesses, not tangible resources and capabilities, such as common distribution channels, common production facilities, and so on.

- The classic example of a firm that has pursued governance economies is General Electric. Throughout the 20th century, GE was a high-performing stock. It was also clearly an unrelated diversifier, operating a television broadcasting network, a jet engine business, an appliance business, a lighting business, and others. However, GE had a management system that spread across the businesses.

- Achieving governance economies is easier to pull off when there's a clear dominant logic or common theme across many businesses. For many years, Emerson Electric was a successful unrelated diversifier, but each of its businesses was in manufacturing, each was in a fairly mature sector, each pursued a low-cost strategy, and each involved a fairly mature technology. Thus, there were common threads, even though the product markets were seemingly unrelated.

- Today, some have begun to question whether GE is still as powerful as it once was in its exercise and execution of governance economies. The spread of knowledge is easy and costless in today's economy, which means that other companies have adopted GE's best practices, and the company may no longer achieve the governance economies it once did.

Unrelated Diversification around the World

- Research by Professor Tarun Khanna has shown that although unrelated diversification may no longer make sense in developed economies, such as the United Kingdom or the United States, the picture may be different in emerging markets, such as India.

- To explain this difference, Khanna pointed to the idea of *institutional voids*. He argued that a capitalist economic system requires the effective functioning of certain institutions that enable parties to enter voluntarily into mutually beneficial transactions. Institutional voids occur when specialized intermediaries are absent.

- *Intermediaries* are economic entities that insert themselves between a potential buyer and a seller in an attempt to bring them together and help them engage in a mutually beneficial transaction.
    - Consider, for instance, a firm pursuing a differentiation strategy in an effort to achieve high willingness to pay.

    - Certain intermediaries, such as *Consumer Reports*, may enable potential buyers to confirm the quality of the firm's products. Other intermediaries, such as a market research firm, may help the company assess consumer tastes. And still other intermediaries, such as government regulatory agencies, may certify high quality.

- There are many intermediaries that help make transactions work in developed economies, such as that in the United States. In the capital markets, there are auditors who verify financial statements. In the labor markets, there are headhunting firms, certification

agencies, and business schools that help match candidates with job opportunities. And through all the markets, there is a judiciary system that operates to enforce the rule of law and property rights.

- But these intermediaries may not exist to the same extent in emerging markets. And a large corporation—an unrelated diversifier—may step into that institutional void to provide that value.

- Khanna has shown that the diversification discount we see in the United States does not exist in, for example, India. Family business groups that are in unrelated businesses are ubiquitous in India, while we no longer see many unrelated diversifiers in the United States. And the percentage of conglomerates trading at discount is below 50% in India, while it's much higher than 50% in the United States.

- The House of Tata, or Tata Group, in India comprises more than 100 companies in seven business sectors, and it serves as a specialized intermediary in a number of ways.
    - For example, in an economy where there aren't clear ways to certify the quality of goods and services, Tata putting its name on a product gives the Indian people confidence that the product is of high quality.

    - For companies that are part of the Tata family, talent for a new business can be reallocated from an established business. Capital can also be moved from a successful business into emerging opportunities.

    - By serving as an intermediary in these ways, Tata makes up for inefficiencies in the market; therefore, it adds value to the businesses in its portfolio in a way that an unrelated diversifier could not in the United States.

- In the United States today, many of the unrelated diversifiers that were successful three or four decades ago have been broken up. The reason for this is that product, labor, and capital markets in the United States have become much more efficient. In the 1960s,

the U.S. economy bore a closer resemblance to an emerging market, with institutional voids and the opportunity for unrelated diversifiers to fill them. Today, with far fewer institutional voids, we see far fewer unrelated diversifiers.

Suggested Reading

Hitt, Hoskisson, and Ireland, *Competing for Advantage*.

Khanna and Palepu, *Winning in Emerging Markets*.

Stewart, *The Quest for Value.*

Questions to Consider

1. What are some flawed reasons for engaging in unrelated diversification?

2. Why might unrelated diversification make sense in certain emerging markets?

3. What are the limitations and deficiencies of the BCG model of portfolio management?

Forward and Backward Integration
Lecture 10

Consider a firm that produces tractors, snow blowers, and other lawn and garden equipment. Traditionally, this company has distributed and sold its equipment through big-box stores, but now, management is pondering a shift in strategy: Should the company open its own chain of retail stores to exclusively sell its own products? The rationale behind this shift is that opening stores will allow the company to capture the profit margin currently being generated by outside retailers. But the firm can't capture the margin without spending a great deal of money to execute the new strategy. As we'll see in this lecture, a company must consider whether forward or backward integration makes economic sense.

Types of Vertical Integration

- Vertical integration comes in two forms: backward integration, which means that a firm produces its own raw materials or components, and forward integration, which means that a firm distributes its own products.

- Apple and its store network represent a classic example of forward integration. Other companies that use this strategy include Ducati, an Italian motorcycle company; Disney; and Fresenius, a company that makes dialysis equipment.

- Apple also engages in backward integration by designing, building, and selling its own operating system. Weyerhaeuser is another company pursuing a strategy of backward integration; the company manufactures paper products and owns its own forests.

Disney's Integration Decision

- The story of Disney's retail stores illustrates a situation in which a strategy of vertical integration may have made sense at one time but, perhaps, became more questionable as different players emerged in the toy retailing business.

- During the 1980s, Disney launched retail stores that initially prospered, but around the beginning of the 21st century, the chain began to struggle financially. Ultimately, Disney struck a deal with Children's Place, a children's apparel retailer, to take over the operation of Disney stores. After several years, however, Children's Place chose to terminate the agreement and turn the stores back over to Disney.

- Disney now faced an important choice: Should it try to operate and manage the stores or shut them down? Times had changed since Disney began its forward integration strategy. People now bought toys on the Internet or from large retailers, rather than independent toy stores. Disney decided to keep the stores, putting Jim Fielding in charge of the effort. He launched a redesign of the stores, with the goal of making them more of an experience that might raise willingness to pay.

- Disney's model here was the American Girl stores, which are deeply experiential. Girls go to the stores not only to buy dolls but also to get dolls fixed in the "hospital" if they're broken, to have lunch with their dolls, to get their dolls' hair done, and so on. Of course, such an experience requires a great deal of investment. A firm must consider whether it can generate enough new revenue to justify the expense.

- In Disney's case, the company also had to walk a fine line between creating too much of an experience, which might steer customers away from its theme parks, and too little of an experience, which might drive customers back to retailers where they could buy toys less expensively.

- One happy medium that some companies have chosen in terms of vertical integration is to operate flagship stores. With this approach, a company might open only a few stores in selected locations. The stores help build the brand and raise willingness to pay for the products, but the company does not retail its products exclusively in those stores or seek to operate a store in every mall in the country.

Rationale for Vertical Integration

- One reason for pursuing a strategy of vertical integration is to counter holdup. Recall the oil refinery and the pipeline. They might vertically integrate because each is so dependent on the other that they can't hold to a contractual agreement in an effective manner. Each is concerned about the opportunistic behavior of the other party.

- Another reason to pursue vertical integration is that there's some synergy between businesses at different points in the supply chain—perhaps economies of scale or scope.

- In addition, a company might backward integrate to secure access to a crucial input. Or a company might pursue vertical integration to foreclose access on the part of competitors—to stop them from having easy access to a scarce input.

- A firm may also backward or forward integrate to offset the bargaining power of suppliers or buyers or to elevate barriers to entry. The more vertically integrated a firm is, the more expensive it is for entrepreneurs to replicate that strategy.

- Yet another reason for pursuing vertical integration is to enhance the ability to differentiate products in the market.

- Finally, vertical integration allows firms to acquire important information that they might otherwise not have access to, such as customer feedback.

Costs of Vertical Integration

- One of the major costs surrounding vertical integration is dulled incentives. With a built-in customer, a vertically integrated manufacturer may not have as great an incentive to perform well as an independent entrepreneur.

- In addition, conflicts of interest may arise. A company that has forward integrated may then compete with its own customers. This is the case, to some degree, with Apple. The firm competes with Best Buy, yet Best Buy is an important Apple customer.

- Vertical integration reduces a firm's flexibility to change suppliers. There are also higher fixed costs and management costs for vertically integrated businesses. Exit barriers rise significantly for vertically integrated businesses. Finally, a vertically integrated firm may experience internal conflicts, especially around the issue of prices charged by one component of the business to another.

Partial Integration

- As an alternative to full vertical integration, some firms have chosen *tapered* or *partial integration*. In this situation, a firm might use both outside retailers and its own stores, or it might use both outside suppliers and its own factories.

- One benefit of this approach is that it exposes in-house units to outside competition, increasing incentives to maximize performance. Partial integration also gives a firm more flexibility and enhances learning because knowledge can be transferred quickly from outside parties to internal units and vice versa.

- Strategic outsourcing might be considered one form of partial integration. In many cases, outsourcing arrangements allow firms to develop deep relationships, cultivating long-term partners but not pursuing full vertical integration.

Declining Trends in Integration

- In recent years, there has been a dramatic decline in vertical integration, particularly in developed nations in such industries as computers and automobiles. The reasons for this decline can be traced by to the transaction cost theory of Coase and Williamson.

- The transaction costs associated with using the market have decreased significantly. In other words, a firm can outsource much more easily today than it could 30 years ago. The web and easier travel and communication around the world have enabled firms to partner with others who may be quite distant.

Case Study: Zara

- A Spanish retailer named Zara has been wildly successful in recent years while pursuing an interesting vertical integration strategy. Zara produces a significant portion of its clothing in factories it owns in North Africa and Western Europe. This approach is different than Zara's competitors, such as H&M and Gap, which don't produce any of their own products. These retailers outsource all manufacturing to low-cost players in Asia or Latin America.

- Zara has pursued a strategy of following the great luxury apparel companies. After new fashions from these companies hit the runways, Zara produces its own similar designs quickly and in small batches for its stores.

- Interestingly, Zara has used a partial integration strategy. It outsources fashion basics, such as t-shirts, to low-cost manufacturers in Asia, while producing other fashions that it wants to be able to change quickly in house.

- Zara realizes a number of benefits from this vertical integration strategy. It doesn't end up with excess inventory if it makes a wrong bet on a particular fashion trend. The company is also able to change its product mix quickly. It doesn't have to commit to buying large quantities of clothing and, as a result, has fewer markdowns.

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Capturing the margin is not a valid reason to pursue integration; a firm must be able to add value by owning different parts of the supply chain.

- Of course, Zara's labor costs are much higher than those of its rivals, but the firm's ability to have fewer and smaller markdowns offsets the labor cost disadvantage. There are also tremendous fixed costs associated with building and operating factories, as well as significant exit barriers. At times, Zara has had to take on debt in order to fund the building of its factories. Finally, the company has had to accept lower asset turnover. It does not generate the same use of assets and efficiency as a company that outsources completely.

- Zara has not pursued the same strategy everywhere around the globe. The company owns its own stores in Western Europe, but in some countries, it has set up joint ventures or franchises to operate stores.

- In writing about Zara, the journalist James Surowiecki articulates many of the philosophies of strategy we've discussed throughout these lectures on strategy. In particular, he notes that imitation of Zara would be difficult because it's an integrated system, not just a collection of parts.

Suggested Reading

Ghemawat and Nueno, "Zara."

Harrigan, *Vertical Integration, Outsourcing, and Corporate Strategy*.

Questions to Consider

1. What is an example of flawed logic used to justify vertical integration?

2. How do some firms achieve stronger competitive advantage through vertical integration?

3. What are some of the pros and cons of pursuing a vertical integration strategy?

Mergers and Acquisitions—The Winner's Curse

Lecture 11

Mergers and acquisitions are part of daily life in the business world. It seems that almost every day we hear of a large company acquiring a small one with an exciting new product or two giant firms combining in a merger of equals. Unfortunately, there are many instances when these deals do not work out; in some instances, they even produce disastrous results. In this lecture, we'll look at the strategic logic behind mergers and acquisitions, the situations in which they make sense, and the situations in which they might actually decrease shareholder value.

Overview of Mergers and Acquisitions (M&A)

- A merger takes place when two firms come together to form a new, combined entity. An acquisition takes place when one company purchases another and takes charge. In some cases, two large companies come together in what they term a merger of equals, but in reality, there is no such thing as a merger of equals. In almost every case, one management team takes charge and asserts its authority over the managers in the other company.

- There is also an important distinction between friendly and unfriendly deals. Of course, a friendly deal takes place when one company acquires another and the selling party is accepting of the deal. In a hostile takeover, however, the target firm is not cooperative in the acquisition. The acquiring firm goes directly to the shareholders and tries to convince them to sell, even if management and the board of directors are against the sale.

- To understand how these deals work, suppose that the stock price of a target firm is \$X per share. The acquiring firm tends to pay a significant premium over \$X per share, sometimes 20% to 40% more than the shares are currently trading at in the market.

- Given that premium, the acquiring firm must believe that somehow the target firm will be more valuable as part of the corporation than it was as an independent entity.

- In other words, the acquiring firm must believe that economies of scope exist, and it has valued those synergies at the maximum premium that it is willing to pay for the target company.

- Acquisitions result in high returns for the target firm's shareholders, but in many cases, the share price of the acquiring firm declines slightly. This decline represents skepticism among investors that the firm can realize the synergies. Keep in mind that an acquiring firm must realize synergies in excess of the premium paid to get control of the target firm, and that is a difficult challenge.

- Many deals don't lead to long-run increases in shareholder value. The synergies that are produced do not exceed the premium that the acquiring firm had to pay. Part of the reason for this is that the target firm is also estimating the synergies. The target tries to understand the added value that will be created if it becomes part of a new entity, and it tries to capture most of the value of those synergies in the price it receives for selling the company. In many cases, the result is that the acquiring firm ends up overpaying.

Valuing Target Firms

- An acquiring firm can use a discounted cash flow technique to value a potential target—estimating the target's cash flows moving forward, then discounting those back to today's dollars. As part of that process, the acquiring firm is not only estimating the target's current financials but also trying to project the synergies into the cash flows going forward.

- There are also other methodologies for valuing a potential target, but the challenge with any of these techniques is that they often include many assumptions that can vary widely depending on who conduct the analysis. The conclusions of an analysis are also

highly sensitive to just a few core assumptions, such as those about expected revenue growth, operating margins, and the challenges of realizing certain synergies.

- Another problem with these analyses is that not enough attention is paid to the costs involved in achieving the expected synergies. Polycom, a company that competes in the telecommunications and video-conferencing business, tries to estimate anti-synergies in its potential acquisitions—something most firms don't do. Polycom looks at the losses it might incur as it tries to bring two firms together.

The Winner's Curse

- Richard Thaler at the University of Chicago has tried to explain why bidders sometimes pay too much with an idea he calls the winner's curse.
    - At an auction, bidders have some value in mind for an object, but they don't know the value that others have placed on that object. The assumption at an auction is that the real value of the object is closest to the average bid.

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The winner's curse is the idea that any winning bidder—at an auction or in the acquisition of a business—inevitably pays more than the underlying real value of the asset up for sale.

- Of course, the highest bidder wins the auction, but if the underlying real value of the object is equal to the average bid, the winner has overpaid. That's the winner's curse.

- In the business world, the winner acquires a company, but it has paid more than the actual value for the company. The winner's curse is Thaler's explanation for the fact that many deals don't generate positive returns for shareholders.

Cost versus Revenue Synergies

- Executives considering an acquisition typically focus more on cost synergies than revenue synergies. In other words, they look at the ways in which expenses will be reduced, instead of thinking about opportunities to generate new sales if two firms are brought together.

- Of course, it's much easier to be explicit about cost synergies. Executives can point to specific layoffs, plant closings, or consolidations that will be executed. Revenue synergies tend to be more nebulous. How can you prove, for example, that a merger will open up new sales opportunities in a specific region?

The Principal-Agent Problem

- Typically, in a large, publicly traded corporation, ownership and control are separated. Ownership is divided up among many shareholders (principals), all of whom own tiny shares in the company. At the same time, control rests in the hands of a chief executive and his or her team (agents).

- Do the principals and agents have the same interests? The shareholders want optimal profits to maximize the value of their shares. The agent is also interested in profits, but he or she—like all individuals—also seeks to maximize personal utility and satisfaction. This might come in the form of monetary compensation, executive perks, power, publicity, and so on. Thus, executives are interested in a number of things that do not concern shareholders.

- The interests of the principals and agents can be aligned through incentives and monitoring.
  - For example, a company might give managers stock options to make them part owners of the company, or managers might be rewarded with bonuses for increasing profitability for shareholders. At the same time, shareholders usually institute a monitoring mechanism in the form of a board of directors.

  - But neither incentives nor the board as a control mechanism is perfect. Agency costs are the resulting misalignment that remains even after good incentive systems and monitoring devices are put in place.

- How do agency costs and the principal-agent problem explain inefficient M&A activity? Many executives may be interested in empire building, not just maximizing shareholder value. And the board may not be in a position to effectively question the CEO's judgment, or the CEO may have control of the board.

Herd Behavior

- Another explanation for M&As that go bad is herd behavior. In an effort to avoid being fired, a CEO might take a risk-averse approach to managing the company—an approach that entails copying other leading competitors. The thinking here is as follows: If others are vertically integrated, and you don't pursue that strategy, you run the risk of looking stupid if the strategy proves to be beneficial to shareholders at rival firms. But if following the herd doesn't work out, you can point to the fact that all of your rivals did the same.

- The late 1990s saw a wave of deals in the entertainment industry. But it seems unlikely that these deals occurred because each firm involved independently concluded that vertical integration made sense in the industry. It was probably the case that each executive team saw others in the industry pursuing vertical integration and decided to follow suit.

- In the early 2000s, the alcoholic beverage industry was also involved in a wave of acquisitions. Interestingly, in cases where two beer companies or two spirits companies came together, the deals worked out, with both companies benefiting from clear economies of scale and scope. But in deals that brought together beer, wine, and spirits, the economies of scope were not as clear and the deals didn't work. Herd behavior was a large part of the reason that the deals were launched in the first place.

Difficulties in Integration

- One of the challenges with any deal is that it's often difficult to integrate two or more companies. There may be obvious synergies with the firms, but realizing those synergies may be difficult. Two scholars, Philippe Haspeslagh and David Jemison, have done an interesting study of this phenomenon.

- Haspeslagh and Jemison concluded that how a firm goes about the acquisition decision-making process, how it does due diligence, and how it approaches the other firm all have a significant impact on the ability to integrate a company.

- Too often we see culture clashes and other friction that prevents the acquirer from realizing expected synergies. Sometimes, problems also arise when a firm that has had a great deal of experience buying small companies suddenly tries to acquire a large one.

Global Mega-Deals

- Scholar Pankaj Ghemawat, an expert in international strategies, has noted that a rule of three seems to have become conventional wisdom in many industries. Executives come to believe that ultimately, a certain industry may involve only three big players. If consolidation is inevitable, the executives seek to execute a merger or acquisition to secure a position for their firm as one of those three.

- According to Ghemawat, the assumption that the global economy is a winner-take-all economy has become common wisdom, but there's no evidence to support that premise. The theoretical links between the globalization of an industry and the concentration of that industry are weak.

- Executives, then, need to break free of the biases that lead them to pursue larger and larger deals. There are better, more profitable strategies for dealing with globalization than relentless expansion.

Suggested Reading

Bruner, *Deals from Hell*.

Ghemawat and Ghadar. "The Dubious Logic of Global Megamergers."

Gupta and Govindarajan, "Managing Global Expansion."

Thaler, *The Winner's Curse*.

Questions to Consider

1. Why do many M&As fail to deliver increased shareholder value?

2. Why do executives continue to pursue so many M&As despite the spotty record of past performance for such deals?

3. What alternatives to M&As might a firm pursue, and what are the pros and cons for these other options?

Launching a Lean Start-Up

Lecture 12

Many people have ideas for new products or services and would like to try entrepreneurship at some point in their careers. In this final lecture on competitive strategy, we'll take a look at the challenge of launching your own business. How can you apply the ideas from these lectures on strategy to building and running a successful venture? And how is entrepreneurship different than leading a large, complex organization?

The Marshmallow Challenge

- The marshmallow challenge is an exercise in which groups compete to build the tallest freestanding structure using only uncooked spaghetti, tape, string, and a single marshmallow. This exercise has been run with many groups of people from different fields and yields some interesting results.

- Recent graduates of business schools underperform the average on this challenge, as do lawyers and CEOs. Engineers, architects, and kindergarten students excel at the challenge.
    - In business school, students are taught to plan, then execute. They learn to set out goals and the means of achieving those goals in as much detail as possible. In the marshmallow challenge, that means coming up with the perfect design on paper before trying to build the structure. Many business school graduates don't even touch the marshmallow until near the end of the time allowed for the challenge.

    - In contrast, kindergarten students tend to pick up the marshmallow early on and start to play with it. In building their structures, they engage in trial and error. Instead of a linear plan-execute process, the kindergarten students do what great designers and entrepreneurs do: They test, experiment, and prototype.

- ○ Tom Wujec, a designer who frequently runs this challenge, has also found that CEOs do better when an administrative assistant joins their team. Wujec argues that because the assistants are good at facilitating work processes, they enable the team to work together more effectively; the assistants help other team members through a testing and prototyping process that leads to a taller structure.

- Peter Skillman, the creator of the marshmallow challenge, once said, "Enlightened trial and error succeeds over the planning of lone genius." This is true not just in building marshmallow structures but in launching new ventures, as well.

The Lean Start-Up

- In the past, the approach to launching an entrepreneurial venture was to conduct extensive market research, write a detailed business plan, and construct pro forma financial statements. In recent years, however, there has been a movement toward a new way of launching a venture, the lean start-up model. This approach is more iterative and less linear than the old one; it involves more learning and adaptation.

- Eric Ries is one of the pioneers of the lean start-up methodology. According to him, every start-up is a grand experiment that attempts to answer a question. But that question is not: Can this product be built? Instead, it's: Should this product be built, and can a sustainable business be built around it?

- This experiment, Ries says, is more than just theoretical inquiry; it's a first product. If it's successful, it allows the entrepreneur to get started with his or her campaign, enlisting early adopters, adding employees to each further experiment or iteration, and eventually, starting to build products.

- Notice that there's an important distinction between this approach and the experience of many entrepreneurs. An entrepreneur may have a great product in mind, but Ries points out that a great product

concept is not a business. A business needs a business model, including an understanding of which customers actually need the product and what they need to get out of it. Meeting those needs involves adaptation, which can be difficult for many entrepreneurs if they fall in love with their own products.

- Ries articulates the notion of a minimum viable product (MVP). You start by figuring out what problem needs to be solved. What pain point is the customer experiencing? The starting point is not your great idea for a new technology but the customers' needs, based on the frustrations they're experiencing with current products and services.

- From there, you develop an MVP, which is that version of a new product or service that allows a team to collect the maximum amount of validated learning with the least effort. The idea here is begin to learn as soon as possible, then adapt, or "pivot," shifting your idea based on the learning that takes place.

- Here, it's crucial not to belabor the planning process but to get to that learning as soon as possible. In other words, pick up the marshmallow early. Get an initial concept, prototype, or product into customers' hands and collect feedback.

- The goal of the MVP is to test certain hypotheses or propositions related to what attributes customers care about, how they define quality, and whether or not they are willing to pay a certain amount for the product or service. These data allow you to determine, for example, whether you can command a price that is sufficient to cover your expenses.

- It's important for entrepreneurs to get comfortable with the idea of "good enough" in order to get the prototype into customers' hands as soon as possible and to listen to the feedback they receive. You must be willing to put out a product that may not be perfect and able to listen to people when they tell you what's not perfect about it.

The MVP Strategy in Large Firms

- It seems that many large organizations cannot pursue an MVP strategy because it's difficult for them to put a "good enough" product into the marketplace. People who work in large organizations are trained to have high quality standards, and the organizations themselves are intent on protecting their brands. Thus, to put out a product that's less than perfect runs the risk of harming the brand and damaging a firm's reputation for quality.

- David Kelley, founder of the leading product design firm IDEO, uses the idea of "failing often to succeed sooner" to drive the innovation process at his firm. This notion is also crucial in the context of entrepreneurship. Entrepreneurs must be willing to put something out in the market that is a "failure"; they must be able to listen to negative feedback and adapt.
    - Again, we can see why large companies have a problem with this. If you're a manager at a large company and your initial attempt at getting a new product into the marketplace is a failure, you run the risk of damaging your career. For this reason, managers in larger organizations tend to be risk averse.

    - Further, the culture of large organizations is such that they're not tolerant of early failures that are simply part of the creation process for new ventures.

- It's important to note, however, that not all failure is acceptable. Entrepreneurs and large companies should not spend inordinate sums to launch new ventures; instead, aim for small experiments and inexpensive prototypes that enable you to get feedback quickly and improve.

Lean Start-Ups in Today's Environment

- There's an argument to be made that it's easier to build and test an MVP today than might have been possible years ago. The cost of computer processing power has come down dramatically, and

open-source software is now available that can help you launch your business. Further, access to capital and talent has generally become easier.

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Yelp pivoted from its initial incarnation as a system for emailing recommendation requests to friends to an online review system of restaurants and local businesses.

- The scholar Vivek Wadhwa has done some interesting research over the years on start-ups, looking at many of them in Silicon Valley, in particular.
    - He has noted that today's laptops have the same processing power as many computers that cost millions of dollars in the 1980s. For storage, you once needed server farms and racks of hard disks, but today, we have inexpensive cloud computing and cloud storage.

    - In short, it's easier to run an experiment today. You can launch a new venture without the need for a great deal of capital. As entrepreneurs like to say, you can rely on fools, friends, and family to get money and get a business off the ground.

- There has also been an explosion in the number of *start-up accelerators*; these are typically groups of experienced entrepreneurs or venture capitalists who coach entrepreneurs in launching new ventures.
    - Start-up accelerators take applications and accept new ventures into a cohort-based, residential program. The entrepreneurs live and work at the location of the start-up accelerator for about 12 weeks, where they get assistance, counseling, and some seed funding. In return, they typically give up a 6% equity stake to the owners of the start-up accelerator.

- The 12-week program culminates in a demo day, where potential investors are assembled, and the entrepreneurs get a chance to pitch their ideas to raise funding.

Gaining Investors

- Venture capitalists often say that they invest in the team, not just the product or the idea. Investors understand that most ventures will have to pivot multiple times in the early days—the idea won't be right at first. Thus, they try to find entrepreneurial teams that are open to new ideas, will listen to feedback, and are willing to adapt.

- In seeking investors, entrepreneurs must also have a business model, not just a product. As we've seen in these lectures, competitive advantage doesn't come from having the best technology or being the first mover in the marketplace. It comes from having an integrated system of activities that delivers value to the customer. That value must be enough to generate returns for investors and provide consumers with some surplus, some value beyond what they paid for the product.

- As an entrepreneur, you must ask yourself a number of questions about launching a new venture: What customer pain point are you trying to alleviate? What is your business model? Who is on your team? Are you willing to adapt and pivot? And perhaps the most important question is this: What makes you different, and can you sustain that position? With the ideas you've learned in these lectures, you should be ready to build on that advantage and defend it against potential rivals.

Suggested Reading

Bossidy and Charan, *Execution*.

Burgstone and Murphy Jr., *Breakthrough Entrepreneurship*.

Ries, *The Lean Startup*.

Wujec, "Build a Tower, Build a Team."

Questions to Consider

1. What questions should an entrepreneur consider before launching a new venture?

2. What advantages does a lean start-up approach have over traditional business planning for new ventures?

3. Where might entrepreneurs seek assistance as they try to launch a new venture?

Critical Business Skills: Operations

Thomas J. Goldsby, Ph.D.

Critical Business Skills: Operations

Scope:

The world is full of great business ideas—products and service concepts that hold immense promise for businesses and the customers they serve. Yet what is the value of a great idea? It amounts to little if a business cannot execute—that is, produce the product or service in conformance with customer expectations in such a way that customers feel great about buying it. In the best case, customers even take pride in their association with products and services they buy. And that's the goal of any company: to develop a band of loyal patrons—or even fans—who not only buy the products but convince others to buy them, too! You know the companies that enjoy this kind of following: Amazon, Apple, Costco, Nike, Southwest Airlines, and Starbucks, among others.

These are some of the companies we'll examine in this section of the course, exploring the ways in which these firms take great ideas from concept to reality by way of operational excellence. Operations is the business activity that enables companies to keep the promises they make to their customers. It includes the sourcing of materials and goods, the conversion of those inputs into something that someone wants to buy, and the delivery of those goods. Quite simply, it's how great ideas get turned into great products and services that a customer can purchase. And operations management is the discipline of getting the most out of a company's people, processes, and technologies.

We'll explore the fundamental aspects of operations that organizations use to translate good ideas into winning businesses, covering such essential topics as inventory management, supply management, distribution and logistics, and performance measurement. We'll take a close look at how companies are competing through supply chain management and examine the latest trends and research on business strategies that enhance agility, resilience, and sustainability. Among the most strategic of all operations decisions is the determination of whether to make or buy—to insource or outsource business activities. This determination is a multifaceted one, subject to the

organization's proclivity for control and its appetite for flexibility. We'll consider how companies can leverage both internal and external resources to extend their reach in the market and ensure profitability.

In light of today's hypercompetitive market environment, organizations of all kinds are seeking to implement processes that create the greatest value for the business and the customers it serves. Companies are emulating the success of legendary operations companies, such as Toyota and its famed production system, in order to maximize value and rid themselves of activities that waste resources and distract the business from its customers. We'll explore how organizations of all kinds can achieve optimal outcomes through implementation of management methods based on Lean Thinking. We will also consider the Six Sigma method for continuous improvement, devised by Motorola in that company's pursuit of variation reduction in its operations. These continuous improvement methods can be applied anywhere that work is performed.

We'll also explore the latest technological developments that promise to revolutionize both operations and business itself. Can you imagine having the ability to pick out a product online, download the blueprint, and have it manifest before your eyes? That's the promise of three-dimensional printing, and companies are putting this technology to work today! General Electric's aviation business is producing critical parts for aircraft turbines through this new-to-the-world additive manufacturing method. Minds in the business world are racing with the potential of such technologies.

Through these lectures, we'll see that operations are instrumental as a value generator and competitive differentiator in every business, ensuring that the right products and services are available in the right form and quantity at the right place and time—and at a competitive price. We'll come to realize that operations management touches virtually every facet of our everyday existence and ensures our quality of life. ■

The Power of Superior Operations
Lecture 13

Operations is the business activity that enables companies to keep the promises they make to customers. It includes sourcing materials and goods, converting those inputs into products that customers want to buy, and delivering the products. Operations management is the discipline of getting the most out of a company's people, processes, and technologies. In these lectures, we'll explore the fundamental aspects of both these activities. We'll cover such essential topics as inventory management, supply management, distribution, and performance measurement. We'll look at how companies compete through supply chain management and examine the latest research on business strategies that enhance agility, resilience, and sustainability. Finally, we'll consider how companies can leverage internal and external resources to survive and thrive.

Vision and Market Strategy

- To understand the role of operations in an organization, we need to know where it fits into the big picture of business decision making. Most companies begin with an overall vision that drives all their functional strategies, including operations. The vision is the statement of how the company wants to be known and sought in the marketplace. Functional strategies establish how the company intends to live up to the promise of its vision.

- The first thing companies typically do after establishing a vision is to devise a market strategy, consisting of the image to be portrayed in the market. In turn, operations strategy is usually regarded as a supporter of the marketing strategy. Depending on how a company wants to be viewed in the marketplace, it will formulate operations to support that vision.

- Harvard professor Michael Porter has identified three competitive market strategies from which a business might choose: low cost, valued differentiation, and a combination of these two.

- Companies using a low-cost strategy seek to win business by having products and services that reflect a price advantage. These products and services are considered of sufficient quality to warrant consideration but are ultimately chosen because they represent good value in the eyes of customers.

- With a differentiation strategy, companies seek to distinguish themselves on merits other than low price. In fact, they try to garner premium prices in light of the uniqueness of their products and services. Differentiation is usually preferred over a low-cost strategy because it tends to result in healthier and more sustainable margins and yields customers who are less likely to be swayed by competitors that offer a lower price.

- The third market strategy identified is a combination of the first two. This approach is rare, though it could be argued that Southwest Airlines implements it quite well. Southwest offers low prices on air travel yet performs high on key operational measures, such as on-time service and customer care.

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Some high-end carmakers employ a differentiation strategy, seeking to distance themselves from competitors based on higher levels of comfort, performance, and aesthetics.

Operations Strategy

- Once a company chooses one of the three competitive market strategies, it must then decide how to execute, devising an operations strategy that supports the vision and market strategy. Again, it's important for the operations strategy to match the competitive market strategy. Buying premium supplies or investing heavily in operations geared toward unique customer outcomes while trying to compete on price won't work, nor will using low-cost, standard-commodity materials while trying to persuade customers to pay for a customized experience.

- Another consideration in the selection of operations strategy is the age of the business. Businesses in their infancy usually start with a single or a limited number of products and services. The size and geography of the market is usually small at the outset of the business, as well. For companies at this stage, a single operations strategy usually suffices. But once the business grows in size and complexity, multiple strategies may be used at once, and they may need to change over time.

- What are the operational differences between a company using a low-cost strategy and one that competes on differentiated products? Let's first consider the low-cost scenario.
    - In competitive markets, low cost usually translates into low prices, and low-cost competitors often find themselves in a "race to the bottom." The combination of global competition and the Internet has sped up this race by providing a greater array of competing options and transparency on prices for goods and services in different markets. This makes price advantages fleeting.

    - When competing based on price alone, Charles Darwin's theories of population ecology come to mind: Only the strong and adaptable survive. If you lay down the challenge of price competitiveness, you essentially try to kill off everyone else in the market, and you become the target that other low-cost providers seek to kill.

- As mentioned earlier, one alternative is to pursue a hybrid strategy, competing on a combination of valued differentiation and low cost. One factor that allows Southwest Airlines to do this is that the company doesn't provide service everywhere in the United States. Instead, Southwest is selective; cities actually market themselves to Southwest in hopes of landing its services.
    - Southwest also keeps costs in check through strategic operations. For instance, it uses a single model of aircraft for all its flights, allowing for standardization in spare parts and maintenance. Further, no first-class service is offered.

    - The picture of differentiation here is not achieved through fanciful offerings or unique approaches. It comes by way of limiting the company's focus and executing well.

Operational Capability: Processes

- Operational capability is the composite of processes, people, and technology used to execute an operations strategy. Processes define "what you do." All work is conducted in processes, and today, we spend a great deal of time studying processes with techniques offered by improvement methods, such as Lean Thinking and Six Sigma.

- Lean Thinking is dedicated to mapping and eliminating waste from processes. Mapping processes enables companies to capture the steps involved in doing work. Some steps are value added, meaning that the customer cares about these activities and is willing to pay for these aspects of the work. Value-added steps usually change the appearance of a product or its performance in some way that's noticeable to the customer. All other steps are considered non–value added and should be reduced or even eliminated from the process.

- Six Sigma is dedicated to reducing variation in processes. When variation in inputs or in work performance exists, you can expect variation in the outputs of the process. Unwelcome variations are called *defects*, which are the enemy of consistent quality and lead to adverse customer experiences.

- In statistics, sigma (∑) is the Greek notation for standard deviation, the mathematical measure of variation. To calculate the capability for a process in terms of variation, it's first necessary to calculate the defects per million opportunities. A *defect opportunity* is any action that strays from the accepted standard for delivery of a perfect product or service.

- This defect calculation then converts into a level of sigma performance. The more sigmas, the narrower the variation band for the process, meaning that the process is operating within very narrow tolerances with less observed variation—and that's the goal.

Operational Capability: People

- Obviously, the people component of capability speaks to who does the work. This so-called soft side of operations is often the "hard stuff" to figure out. Humans are complex creatures, and understanding what might motivate one person, let alone large groups of people, is extremely difficult.

- One consideration that factors into the critical role of people in operations is automation, which continues to be on the rise in many settings. But not all work lends itself to automation. Specifically, automation struggles with nonstandard tasks or situations. Further, in some circumstances, customers prefer interacting with another person, as opposed to a computer screen.

- It seems that at least for the foreseeable future, we will continue to rely on people to perform many critical tasks. But a fundamental question that companies must ask when executing an operational strategy is whether they will do the work themselves (*insourcing*) or whether they will hire others to do the work on their behalf (*outsourcing*).

Operational Capability: Technology

- The final component of operational capability is technology, specifically, the assistance received from both equipment and information technology to enable higher-performing processes. Technology lends great convenience and enhanced capabilities to work and everyday life, but it should not drive strategy. Business strategies that rely first on technology can be too easily duplicated by competitors—and leapfrogged when a better technology comes along. Competitive advantage achieved through the other aspects of capability—processes and people—can be more difficult to copy.

- The idea of technology as an enabler of process refers to the use of technology to help make sense of complex situations or those laden with data and information. Decision support tools, such as statistical software and business analytics, can help with these problems. In addition, data capture and communicative technologies can help when a company is unable to "see" a process and its performance. GPS, for instance, is wonderful technology for illuminating an otherwise hard-to-see process from afar.

- Finally, any physical equipment that might be used to lighten the load or speed up the work also represents technology. Companies should embrace equipment technology when it advances processes and allows them to avoid sending people into hazardous situations.

- The challenge of operations management is to use operational strategy to guide the processes, people, and technology that constitute operational capability to achieve business success. This isn't a quick or easy task, and once you think you've got it figured out, it's probably time to revisit the decisions. All organizations—from start-ups to multinational corporations—must adapt to stay relevant to customers, and adapting the company's operations is a critical part of that process.

Suggested Reading

Browning and Sanders, "Can Innovation Be Lean?"

Davenport, Mule, and Lucker. "Know What Your Customers Want Before They Do."

Schroeder, Goldstein, and Rungtusanatham, *Operations Management in the Supply Chain*.

Simchi-Levi, *Operations Rules*.

Questions to Consider

1. Why is it important to link a company's operations strategy to the overall business strategy?

2. How can an operations strategy provide identity for a company?

3. Can you think of examples of companies that win in the marketplace through distinctive operations strategies or well-executed operations?

Leaner, Meaner Production

Lecture 14

As we saw in the last lecture, operations is the business activity that fulfills the promises that companies make to their customers. It includes sourcing materials and goods, converting those inputs into something that customers want to buy, and delivering the goods. Production operations are those that involve the provision of actual goods as opposed to services. Production operations for physical goods are also referred to as manufacturing operations and have the primary function of converting inputs into desired outputs for customers. They represent the greatest value-adding activity in all of business, transforming the useless into the useful.

The "Make-vs.-Buy" Decision

- One of the most fundamental decisions that any company interested in selling products must make is whether to produce the product in-house or to hire an outside company to manufacture the product on its behalf. This determination of insourcing versus outsourcing is often called the "make-vs.-buy" decision. Both options are considered part of production operations, but they involve different organizational arrangements.

- In making this decision, the place to start is with simple economics: determining what it would cost your company to produce the product—taking into account fixed capital costs and the costs of running the operation—versus what a contract manufacturer would charge for its services.
    - Complicating this analysis is the expectation of future sales. If the product is a big hit, you could cover your fixed-cost investments with the increasing sales volume, but you might also have to expand operations in a hurry.

    - Another complication can arise when customers ask for different items or unique packaging. Just as we consumers seek unique, differentiated products, so, too, do business customers.

Large retailers and distributors want to be able to offer product assortments that can't be found anywhere else. That can create a problem if you sell to and through many different retailers.

- Contract manufacturers excel at making adaptations because manufacturing is their core competency. They tend to have skills in developing proper tooling and quick changeovers from one product to another. They can also offer economic advantages because the production facility is shared with multiple clients, and costs are spread across these clients.

- For these reasons, many young companies that are bringing products to market for the first time choose outsourcing over insourcing. They can get into business without having to build a factory and invest in manufacturing equipment and a trained workforce.

- However, there are also disadvantages to outsourcing, the most significant of which is control. You take the risk that the contract manufacturer won't have your best interests at heart when producing your goods. There's even the risk that a company that learns how to make your product could steal it.

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It's estimated that the global market for contract manufacturing in electronics is more than $450 billion.

- For that reason, you need to analyze the transaction costs associated with hiring an outside party. Transaction cost analysis (TCA) is a distinct branch of economics that examines the costs of monitoring another party to act on your behalf.

Outsourcing Considerations

- Companies that outsource often opt for suppliers in countries where wages for labor are lower than in developed economies—a practice known as *offshoring*. However, some companies have later retracted this decision when they find that they've underestimated the transaction costs and the amount of oversight required with offshore manufacturing. This is particularly true when manufacturing problems make product recalls necessary.

- Another circumstance that would warrant reconsideration of outsourcing is the discovery of labor abuses at contract manufacturing locations. Public pressures and, increasingly, government regulations are forcing companies to be more transparent about who they hire, where suppliers are located, and the standards in place to ensure that work practices are consistent with Western norms.

- If you still elect to hire an outside manufacturer—despite these cautions—work with an attorney who is seasoned in negotiating such deals. This is especially important when doing business across national boundaries.

Manufacturing Strategies

- If you decide that you're better off making your product yourself, you first need to decide what manufacturing strategy you will use. There are five primary strategies to consider.

- The first strategy is called *ship-to-stock*, or a *full anticipatory strategy*. Under this strategy, companies put complete faith in their sales forecasts, using those numbers to drive purchasing, production, and distribution. In other words, a company builds and distributes products in advance of demand and hopes that it has estimated correctly.

  - Companies use this strategy in situations where customers expect to find the product on the shelf, buy it, and make use of it immediately. Thus, this strategy is used for virtually everything sold in, for example, grocery stores.

  - Of course, with this strategy, when you underestimate demand, you are left with disappointed customers. And when you overestimate demand, you're left with extra inventory that you may need to mark down or even write off.

- One step away from ship-to-stock is the *make-to-stock strategy*. In this case, companies buy materials in advance and manufacture products in accordance with sales forecasts, but they do not allocate the goods to distribution locations until they receive customer orders and know exactly where to ship.
  - This delaying of the delivery step allows companies to hold inventory centrally for all distribution locations and, thus, get by with lower inventories.

  - But holding inventory centrally and postponing delivery until orders are in hand means that customers have to wait for delivery.

- The next strategy is called *assemble-to-order*, *configure-to-order*, or *mass customization*. With this strategy, materials are procured in advance of demand and products are made only to a semi-finished state. The finished product doesn't take shape until the company learns exactly what the customer wants. This strategy is ideal for basic products that can be sold with small differences.
  - This strategy allows a pool of common inventory to cover the needs of customers who are looking for something slightly different, again, reducing inventory requirements but requiring additional time to perform the final touches on the goods and deliver them.

  - Toyota provides an excellent example of mass customization with its Scion brand of cars. The cars are manufactured to a generic state in Japan but held in large supplies by major

U.S. distributors. Customers select options from the company website, and when an order is confirmed, the closest distributor alters the base model according to the customer's requests.

- ○ Through this assemble-to-order strategy, Toyota is able to provide customers with seemingly limitless choices yet with much less inventory than if the company pre-built cars to cater to customer demands. However, under this system, customers have to wait a few days or a few weeks to take possession of their cars.

- The fourth manufacturing strategy is the *make-to-order strategy*. In this scenario, the manufacturer has the raw materials on hand but does not commit to assembling them until receiving a customer order. In delaying the assembly process, the manufacturer has even more flexibility to accommodate diverse customer preferences related to product form and function. Such a strategy might be used for a highly customized luxury vehicle.

- The fifth strategy is the least speculative of all for the producer: the *buy-to-order strategy*. Here, the producer awaits the customer order before even purchasing the raw materials. This allows for products to be truly custom-built, but customers must expect longer wait times under this system. Such arrangements are sometimes used in the provision of large industrial products, such as aircraft or satellites, or in homebuilding.

- Large manufacturers often use multiple strategies to accommodate their varieties of products. Smaller companies generally start off with one of the less risky and less speculative strategies, such as buy-to-order or make-to-order, so that they can conserve cash for investments other than inventory.

- Lean Thinking has had a significant influence on the management of inventory as it relates to production strategies.

- Traditionally, companies relied on inventory to deal with a variety of problems. For example, the problem of inaccurate sales forecasts or unreliable suppliers can be solved just by having more than enough inventory to cover any shortfalls or late shipments.

- Lean Thinking, however, encourages companies not to rely on inventory. Instead, companies should improve their forecasts or design flexible operations that make them less dependent on forecasts and more responsive to actual demand. Companies are also encouraged to work only with reliable suppliers or to help existing suppliers deliver better materials more reliably.

Developments in Production Operations

- Advanced technologies are making significant changes in the world of production operations. In fact, one major development is threatening the entire system of factory-based mass production that we have known over the past century. This revolution is the advent of three-dimensional printing, creating what's known as *form-on-the-spot*.
  - This technology has found use in the production of models and prototypes in recent years, but the prospects for using form-on-the-spot production have set minds racing in the operations field. Just as we now download music and books from the Internet, imagine downloading three-dimensional blueprints, hitting the print button, and watching physical goods take shape right before your eyes!

  - To date, three-dimensional printing is limited to simple products with simple materials. That situation is changing quickly though; such companies as General Electric are making significant investments in advancing the manufacturing capabilities of the printing equipment.

- Another development to watch is the rise of *nearshoring* and *reshoring*. Although some companies continue to favor outsourcing of manufacturing operations to suppliers in low-cost countries, there is also a trend in the opposite direction.
    - Companies have learned that it's difficult to anticipate all the things that can go wrong with offshoring, such as frequent power outages, high labor turnover, and so on. In reaction to this reality, many companies that once offshored to low-cost countries are regionalizing their supply chains, meaning that they are seeking to produce closer to the markets they're trying to serve.

    - *Nearshoring* refers to the practice of producing close to the focal market, probably in a location that still offers some cost advantage but with less uncertainty than far-off locations. *Reshoring* refers to bringing once-offshored manufacturing back home.

- Finally, the next significant wave of innovation in production operations may come with the focus on sustainability. Our ability to serve a growing population in a more sustainable fashion will be at the forefront of corporate decisions and national policy in the coming years. This could mean choosing different materials and creating products using manufacturing processes and energy sources that don't pollute the air, land, or water.

- Production operations is a key factor in all these developments. Whether it drives them or simply incorporates and adapts to them, it will be central in the years ahead to some of the most dramatic changes in how we live, how we create, and how we interact with our planet.

Suggested Reading

Kazmer, “Manufacturing Outsourcing, Onshoring, and Global Equilibrium.”

Shih, “What It Takes to Reshore Manufacturing Successfully.”

Simchi-Levi, Peruvankal, Mulani, Read, and Ferreira, “Is It Time to Rethink Your Manufacturing Strategy?”

Williamson, “Outsourcing.”

Questions to Consider

1. Why would a company elect to outsource the production of products bearing the company’s brand name? What are the risks inherent in outsourcing?

2. How do you select the right manufacturing strategy for a product? What makes it the “right strategy”?

3. How does the pursuit of sustainability affect decision making in production operations?

Refining Service Operations

Lecture 15

Over the past several decades, the United States has seen a major shift in its economy—from being dominated by manufacturing to focusing more on services. This shift is reflected in the fact that today's services sector represents nearly 70% of the nation's gross domestic product. In addition, six out of seven people in the workforce are employed in services. In this lecture, we will examine the essentials of managing successful service operations, taking into account the complex psychology involved in winning over customers through great experiences. As we'll see, there are significant differences between service operations and product-oriented operations, yet service operations can still borrow some important concepts from the science of the production world.

Defining *Services*

- The term *services* refers to a wide variety of activities, from consumer services, such as health care, restaurants, retail, and banking; to industrial and professional services, such as advertising, transportation, and legal services; to government and civil services, including schools, emergency services, and postal delivery.

- Perhaps the most fundamental difference between production operations and service operations is the intangibility of services as a deliverable.
    - Although service operations may sometimes have some of the attributes of physical products, the deliverable in services is an outcome or experience for the customer.

    - In some ways, this can make the management of services more complicated and challenging than making a physical product, where the specifications and requirements tend to be more concrete.

Assessing Services

- One of the most significant developments in modern service operations has been the establishment of the service quality scale (SERVQUAL). Devised by academics, SERVQUAL is a measurement system dedicated to assessing customer satisfaction with services. It has revolutionized how we think about and assess service delivery.

- SERVQUAL's basic premise for discerning customer satisfaction is simple: It compares the customer's perception of the service as it was actually rendered against the expectations the customer had going into the service arrangement. If the perceived performance exceeds expectations, then the customer is satisfied. If expectations are not met, the customer is said to be dissatisfied.

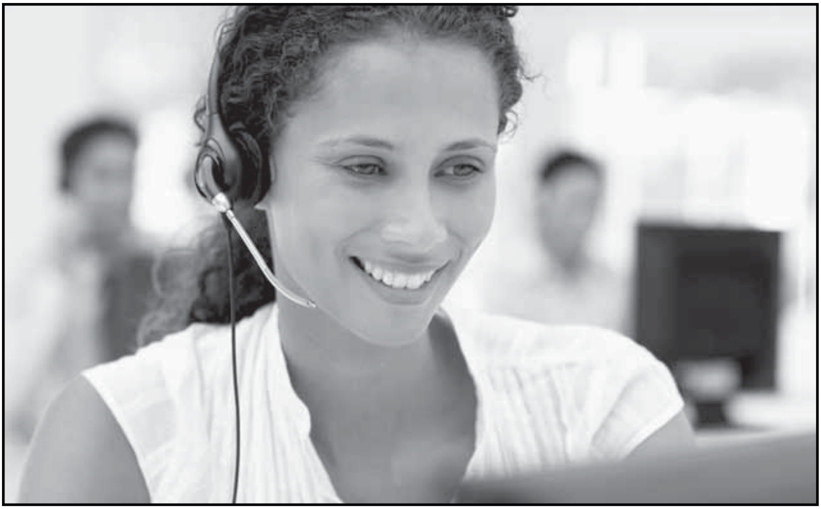
- SERVQUAL assesses service quality by comparing expectations and perceptions of performance across five important dimensions. These dimensions, listed below, form the acronym RATER.
    - Responsiveness: how promptly the service provider responds to the needs of the customer.

    - Assurance: the level of the customer's ease that the service will be conducted in accordance with his or her wishes.

    - Tangibles: the physical aspects of the service provision, including the facilities, equipment, and personnel that will shape the customer's experience.

    - Empathy: the sense of caring and understanding extended by the service provider to the customer.

    - Reliability: the ability to perform the service on a dependable and accurate basis compared to what is promised.



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Arguably, building relationships is of much greater importance in service industries than in production businesses because service comes down to trust—trusting that the outcome will be what the customer is seeking.

- In addition to providing a scale of service quality, SERVQUAL also identifies several *service gaps* that can irritate or repel customers. These include an inability to match performance with expectations, differences in expectations between the provider and the customer, and the perception of performance.

Process Improvement: Lean Thinking

- Because effective service is so important to meeting customer demands, a field of study known as *process improvement* has developed for refining service operations. This discipline comes from production operations.

- All work—whether it's manufacturing widgets or making espressos—is completed in processes, and each process involves a series of steps in which inputs are converted into outputs for a customer. The two most influential methods for process improvement are already familiar to us from the production operations context: Lean Thinking and Six Sigma. The premise

of both these methods is that all processes can be improved. This reasoning is particularly true in services because they rely on people, who are prone to errors.

- One principle of process improvement that can help achieve high-performing services is the concept of *standard work*. This involves finding the best way to complete a work task, documenting it, and teaching it to others. This is a simple idea, but it's hard to achieve in service environments, where operators tend to develop individual patterns of behavior. And when no standards exist for work, you can expect different qualities in the outcome. The challenge for services is to provide consistently good outcomes for customers.
    - In 2009, Starbucks set out to address this problem by setting up its Lean Innovation Lab. The goal was to develop and test different ways to perform store routines in search of the best way to perform all varieties of work, including cleaning up, restocking displays, and preparing coffee.

    - The initiative had numerous benefits. By finding and standardizing its best practices, Starbucks ensured a cleaner and more appealing sitting area and reduced the amount of time and wasted motion involved in brewing and serving coffee. Creating standard work routines resulted in achieving positive customer experiences more consistently, which has fueled top-line growth and reduced costs.

- Another valuable way to apply lean principles in service settings is to compare process time with *takt time*. *Takt* is a German term that refers to the targeted or goal time for an activity—the amount of time in which an activity must be completed in order to keep pace with demand. In contrast, *process time* refers to the amount of time required to actually complete the activity.
    - Consider, for example, a men's grooming salon. The owner of the salon would like to achieve as much throughput as possible in the shop. Many of the costs associated with the shop are fixed; thus, the more customers served, the more revenue and profit can be achieved.

- ○ Let's say that on average, it takes 20 minutes for a stylist to give a simple haircut. This is the process time for the work. Over the course of an 8-hour day, a stylist could serve 24 customers, or 3 per hour. But what if the shop has demand for 80 haircuts a day? Clearly, that demand cannot be met with one stylist because it translates to 26 ⅔ hours of work.

- ○ The takt time to keep pace with this demand is determined by dividing 8 hours (480 minutes) by 80 customers; the result is 6 minutes. But the process time is more than three times that! Clearly, the owner will need more resources to serve 80 customers in 8 hours.

- ○ This comparison of process time and takt time can be helpful in determining the amount of resources needed to get a job done in an allotted amount of time. But the real lesson here is not to simply take these numbers as a given. By finding the best way to perform the work, companies can reduce the process time required to serve their customers, making them better able to meet greater demand.

- Another variable that companies sometimes overlook when managing the supply-demand equation is their ability to alter demand through pricing. That's not a service operations decision per se, but it can have a significant impact on the provision of services. For example, Dell has long used a "sell-what-you-have" strategy that drives customers to the products the company has high in inventory and away from items that are at risk of going into backorder. This is accomplished by simply changing the price for these items in a dynamic manner.

- Related to the pace of demand, something that anyone working in services knows is that if you have to staff a business at all times to handle unexpected peaks in demand, you'll have significant downtime. To address this problem, Lean Thinking sets forth the concept of *heijunka*, a Japanese term that refers to the smoothing

out of demand. Such smoothing out can be accomplished by offering discounts or other promotions to drive business to off-peak times and avoid the problem of paying staff to sit idle.

Process Improvement: Six Sigma

- The Six Sigma approach can also be applied to service environments. As mentioned earlier, the term relates to the standard deviation in a process. Standard deviation is a measure of variation. When there is variation in inputs or variation in how work is performed, the result will be variation in outcomes.

- Six Sigma encourages businesses to root out the sources of variation and establish greater precision in how work is conducted. This approach refuses to accept the idea that to "err is human" and seeks to eliminate the sources of error—not the people but the actions they perform that lead to error and defects.

- By definition, Six-Sigma performance is achieved when defects number fewer than 3.4 per 1 million opportunities for defect. Achieving that level of defect-free performance is probably not attainable in human-driven processes, such as those found in most services. But whether an organization achieves 6 sigma, 4 sigma, or 2.5 sigma is not what really matters. What matters is whether the company and its processes are improving. And if the firm is improving faster than its competition, that bodes well for the future.

Service-Dominant Logic (SDL)

- One business theory that has drawn a good deal of attention recently is *service-dominant logic* (SDL), which to some degree unites the principles of service operations and production operations. SDL suggests that businesses move away from marketing goods to a notion of co-creation of value. The idea is that in a purchase situation, customers are buying more than just a product; they're buying the ability to use the product in the pursuit of enjoyment. There is an ongoing relationship between the customer and the product, and that creates new business opportunities for the provider.

- This is a fundamentally different way to view a product and, in turn, to sell the product. It is not an end in its own right but part of a solution. We see similar transitions to a solution orientation occurring in many industries. Xerox, for example, has moved away from selling copiers to business customers. Instead, it installs a multifunction copier in an office, and the customer is charged for its use based on pages copied and documents scanned, printed, and mailed. This shift in orientation has turned what might have been one-time sales into lucrative, ongoing revenue streams.

- Notice that there is a physical product at the center of the services that Xerox provides. The new focus, however, is on a creative solution that doesn't involve dumping the product in the lap of the customer, then walking away. Rather, it involves establishing and maintaining a relationship with the customer. It becomes much more difficult for competitors to sway customers with grandiose promises when customers trust your company to deliver desired outcomes reliably.

Suggested Reading

George and George, *Lean Six Sigma for Service*.

Hsieh, "Zappos's CEO on Going to Extremes for Customers."

Kastalli, Van Looy, and Neely, "Steering Manufacturing Firms towards Service Business Model Innovation."

Ramdas, Teisberg, and Tucker, "Four Ways to Reinvent Service Delivery."

Rawson, Duncan, and Jones, "The Truth about Customer Experience."

Zeithaml, Parasuraman, and Berry, *Delivering Quality Service*.

Questions to Consider

1. What makes the provision of services different from production operations? Is it easier in some ways and harder in others?

2. Name a service company that you would consider great. What makes this company great?

3. How do the principles of operational excellence found in Lean Thinking and Six Sigma help a service business to compete more effectively?

Matching Supply and Demand

Lecture 16

Sales and operations planning (S&OP) is a proven method for finding the balance between promise making and promise keeping. The process consists of the integration of a company's sales forecasts with the operations plans from the purchasing, production, and logistics departments. In this lecture, we'll examine the specific inputs and organizational requirements needed to achieve this balance.

Background on Sales and Operations Planning (S&OP)

- Most businesses are composed of different departments, such as sales, marketing, accounting, purchasing, production, logistics, R&D, and HR. The reason for this is that humans deal with complexity by becoming specialized, developing knowledge and skill sets that allow us to perform specific functions.

- A functional orientation helps us ensure that we "cover all the bases" in an organization, but it's sometimes difficult to establish balance and coordination across the departments. This is particularly true when the departments are in conflict with one another. There is a natural tendency in times of conflict to defend our turf, rather than to give in and pursue outcomes that might benefit the collective good. Further, companies often have measurement systems in place that reinforce "functional silos" and turf wars.

- Perhaps the greatest divide found in organizations is the one between the demand and supply sides of the business. The customer-facing departments responsible for generating demand—namely, sales and marketing—are held accountable for top-line revenue. Meanwhile, the supply-side operations departments, such as purchasing, production, and logistics, have the responsibility of delivering on that demand but doing so at the lowest possible cost to ensure that the company nets margins and profits.

- These two forces often find themselves at odds. The promise makers in sales and marketing blame operations for an inability to satisfy the demand they've worked to create. At the same time, the operations personnel take offense at what they see as sales and marketing's casual approach to making promises that probably shouldn't have been made in the first place.

- It's important to get promise makers and promise keepers on the same page because failing to deliver on customer orders or being forced to temper demand affects the company's credibility in the marketplace and creates opportunities for competitors. Undersupply opens the door for the competition, and oversupply leaves excess inventory that must either be marked down or written off. Sales and operations planning (S&OP) was designed to address these problems.

- Fundamentally, S&OP is about gathering and sharing information. Thus, the first step is to form an S&OP team of senior departmental representatives from within your company and gain the buy-in of the parties involved. As the term *S&OP* suggests, the key function of this team is planning.

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The goal of the monthly S&OP team meeting is for all parties to arrive at a common vision of what's expected in the coming month and to share a commitment to doing their part to fulfill that vision.

- The sales and marketing representatives should work together to bring forward the sales picture for the coming months.

- The purchasing, production, and logistics reps prepare capacity plans, with ready explanations for any anticipated changes in operating capacity.

- Finance and HR play consultative roles related to the deployment of financial and human resources.

- New product development speaks to the readiness and timing of product launches that can be expected to siphon resources from existing products.

Sales Forecasting

- Considerable work takes place within each department leading up to the monthly meeting of the S&OP team. Sales and marketing should collaborate to coordinate promotions and other strategies that might be in place to bolster sales. These team members also generate short-term sales forecasts, typically covering a period of one to three months. Sales forecasts come in one of two varieties: qualitative or quantitative.

- Qualitative forecasts are essentially best guesses—forecasts made without necessary data; however, these forecasts are not shots in the dark. They rely on the opinions of experts who are closest to the market—field sales representatives and headquarters marketing managers. These experts base their judgments on market intelligence, including trends for sales of related items, demographic changes, and responses to market inquiries and field testing of products or services. In the absence of sales history—as with completely new products—qualitative estimates are often the best options available.

- Quantitative forecasting methods come in many different forms. Ideally, they rely on data from past sales of the same item. In the absence of this information, they might use historical sales of similar or complementary items.
    - The easiest but least informed quantitative forecast is a *simple average*. Here, a company divides the average sales over an entire year by 12 months and makes its plans with the expectation of selling approximately the same volume each month.

    - The *moving average* technique looks at recent history only—perhaps the last 3 months—to gauge the anticipated sales for the month ahead.

    - *Exponential smoothing* looks at the previous month's sales forecast and the actual sales from that same month. An *alpha value*, or *smoothing factor*, is then applied that governs how much emphasis is placed on each factor. The sum of actual sales multiplied by alpha and forecasted sales multiplied by −1 alpha yields the forecasted value for the coming month. This approach is intended to take some of the emotion out of the forecast while still relying on recent data.

    - The *regression analysis* method offers a predictive model that allows many factors to be considered at once, including the unique influence of trends, seasons, and cyclical influences. This method is used for products that have been in existence for some time and for which extensive sales data are available.

- Most companies use a combination of quantitative and qualitative forecasting methods. The ideal approach is to generate a quantitative forecast as a baseline, then have experts weigh in on those numbers. Were there unusual occurrences in recent months that affected the historical data? Are there any expected occurrences in the near future that could affect the forecast? Blending historical data with expert opinion brings together the best of both worlds.

Capacity Planning

- The other side of the S&OP equation is capacity planning, specifically, planning for supply, production, and the combination of logistics and distribution. Limits in any of these can impair the company's ability to accommodate the expected demand found in the sales forecast.

- Supply capacity probably rests beyond the direct control of your firm. It's dependent on the capacity of your suppliers and your ability to extract supplies from them. Typically, companies have some suppliers that seem to be able to offer limitless supplies and others that present constraints. The constraints may be absolute, meaning that there are limits to these suppliers' ability to serve you, or the added volume may simply come at a price. Companies need to understand both of these because they can influence the volume and price of supplies that can be acquired.

- Supply and production capacity come together in the materials requirements plan (MRP), which expresses the quantity and timing of supplies required to feed production. The MRP is usually driven by the production forecast, or the master production schedule (MPS). This schedule illustrates what the company expects to produce over a period of time, often a month, and can be broken down into weekly or even daily plans for production. Clearly, the sales forecast should influence this production forecast.

- The third capacity plan necessary for S&OP is one for logistics and distribution. Here, there may be capacity constraints on how much product can be stored and moved over a period of time. That capacity may be limited by warehouse space available, the size of storerooms, or the number of transportation vehicles available. Your company may own these capacities, or it may hire outside companies to provide the required space and transport.

Flexibility in S&OP

- With the compilation of the sales forecast and capacity plans for supply, production, and logistics and distribution, you have what you need to make decisions at the S&OP planning meeting. The goal of the meeting is to come up with a single set of numbers that everyone will work toward in the coming period.

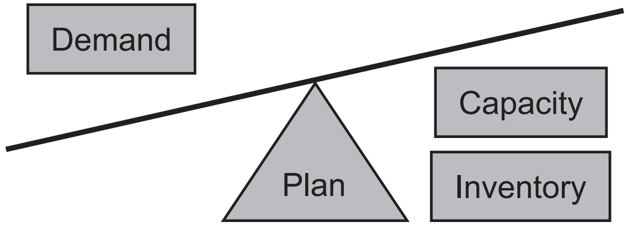
- However, the S&OP process doesn't end with agreement on a common set of numbers. Once the month begins and sales start to trickle in, everyone needs to communicate about potential problems with the forecast. The same is true for operations plans. Countless forces could be at work, threatening to alter your best-laid plans for meeting demand.

- The often-forgotten component of S&OP is flexibility, which must be built into operations to accommodate the unexpected. The more flexible your operations, the more variation your system can accommodate and the less likely your customers are to experience any negative consequence as a result of fallible planning. Should you not be able to accommodate customer needs, you must devise priorities to determine which customers to serve with your limited supplies.

Integrated S&OP

- These same principles for managing supply and demand within a company can also be applied across companies in the *supply chain*, meaning the entire system of inputs, outputs, and distribution. That is, companies can collaborate with suppliers and customers to realize a common vision of the business they will conduct together.

- To understand this idea, imagine a see-saw. On one end is a large box labeled *Demand*. On the other end are two smaller boxes labeled *Capacity* and *Inventory*. Positioned in the middle of the see-saw is the fulcrum on which it rests, labeled *Plan*.



The see-saw analogy captures the benefits of integrated business planning; in the event of increases in Demand, moving the Plan closer to the Demand side allows companies to get more leverage from existing Capacity and Inventory.

- The see-saw is in balance when the weight of the Capacity and Inventory together counter the weight of Demand. If Demand were to grow, more weight would be needed in Capacity and/or Inventory to bring the see-saw back into balance. Yet there is another possibility—the fulcrum. What if you were to move the Plan closer to the Demand side of the see-saw? With that action, you get increased leverage from existing Capacity and Inventory.

- The lesson here is that if you can plan closer to demand—that is, forecast demand more accurately—then you need less capacity and inventory to fulfill demand. The answer is sharing information and collaborating within companies to find the balance between demand and supply.

- Now, imagine lining up multiple see-saws side by side and working with people at each one to find the right balance for each of the see-saws in tandem. That would represent the notion of *integrated business planning* across companies in the supply chain. No doubt, it's a challenge, but it's one that yields significant benefits for the players.

Suggested Reading

Box, Jenkins, and Reinsel, *Time Series Analysis*.

Kahn, "Solving the Problems of New Product Forecasting."

Muzumdar and Fontanella, "The Secrets to S&OP Success."

Stahl and Wallace, "S&OP Principles."

Wallace and Stahl, *Sales and Operations Planning*.

Questions to Consider

1. How does the struggle between promise making and promise keeping shortchange or challenge the performance of a company? Why is it important to keep these two in balance?

2. We know that forecasts will not be perfectly accurate. What are the implications of this fact for our capacity plans? Is it wise to build in extra capacity to deal with peak demand?

Rightsizing Inventory

Lecture 17

Inventory can be among the most valuable assets for a company—and it certainly seems that way when you don't have enough to feed your business or serve your customers! But having too much inventory can be a bad thing, too. Even if it's just in storage, inventory can consume many resources in your business—resources that could be put to more productive use elsewhere. In this lecture, we'll explore the fundamentals of rightsizing inventory through inventory management. The primary goal of inventory management is to determine what to inventory and in what quantities to maintain just the right amount of inventory—no more and no less!

Inventory Management Metrics

- Companies hold inventory in the hopes of generating more sales and in fear of facing a *stockout*—a lack of inventory—resulting in the inability to serve customers. But holding inventory is expensive. The financial impact of holding inventory is measured in the form of *inventory carrying costs*, or *holding costs*. The more inventory a business holds, the higher these carrying costs are.

- The primary component of inventory carrying cost is the opportunity cost of capital, that is, the cost of having money tied up in inventory that could be put to use elsewhere in the business, perhaps in new technology or staff training. In addition to the opportunity cost of capital, the inventory carrying cost calculation also includes insurance and taxes associated with holding inventory. And there are risks to holding inventory, including the risks of the inventory becoming damaged, stolen, obsolete, spoiled, or out of date.

- Aside from inventory carrying cost, a key metric of inventory management performance is *inventory turns*. This measure can be calculated on an item-by-item basis or across a company for all its items. The aggregate calculation provides an overall measure of inventory efficiency. It's calculated by dividing the cost of goods

sold by the dollar value of average inventory. A company that can generate more sales on lower inventory has a higher number of turns, suggesting a more efficient operation.

- The item-specific measure of inventory turns provides a good read on the company's efficiency with respect to an individual item.

- For instance, an item that generates 20 turns a year compared to another that generates only 5 is four times as efficient from an inventory standpoint. The 20-turn item might be labeled a "fast mover," and the 5-turn item might be a "slow mover." Fast- and slow-moving items can be managed differently in light of the different burdens they impose on the business.

- Increasingly, companies are using inventory turnover not only as a means of self-evaluation but also as a way to evaluate their suppliers. Many large retailers, for instance, use a measure known as *gross margin return on inventory* (GMROI) to evaluate the attractiveness of a supplier's goods. This is a hybrid measure that combines gross margin and inventory turns in a single metric.
    - Let's say that an item enjoys a 20% margin for the retail store but turns only three times per year. The GMROI would be $0.2 \times 3 = 0.6$. Some sources claim that an item must achieve a 3.2 GMROI to break even, but that's a broad guideline.

    - GMROI offers a good way to compare different items within a product category and can help retailers decide which items to stock and where to stock them.

Product Proliferation

- Product proliferation, or the growth in the number of items a company stocks, is among the greatest challenges facing businesses today. Companies are eager to introduce new items, believing that doing so drives sales growth, and that's often true. But companies are also reluctant to eliminate items. The result is an ever-growing assortment of items that add cost and complexity.

- Small businesses are especially prone to this problem. When a business is small and trying to grow, it wants to promise the world to its customers, but the weight of inventory to fulfill that promise is simply too heavy. Believe it or not, poor cash flow resulting from holding too much inventory can be blamed for more failures among small businesses than almost any other culprit.

- Having only one or a few brands within a product category is the driving strategy of such grocery retailers as Save a Lot, ALDI, and Trader Joe's. By carrying only one item in most product categories, these stores manage their inventory much more efficiently and, in turn, offer more competitive prices for their products.

Inventory Management Strategies

- There are four basic inventory management strategies. These strategies can be distinguished based on how a business interacts with its suppliers in choosing how much and how often to order.

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With today's inventory-tracking technologies, many companies monitor inventory at all times and manage accordingly.

- The simplest option is a *fixed quantity–fixed frequency strategy*. With this strategy, a business orders the same quantity every time an item needs to be replenished, and the order is placed on a scheduled basis.

- The next strategy is the *periodic review method*, or *P-system*, where *P* stands for a fixed *period* of review. This strategy is also sometimes referred to as a *min-max approach*.
    - Once an inventory count is taken (perhaps every 10 days) and it's realized that a reorder point has passed, managers order up to a maximum level for that item—a predetermined quantity that the company is willing to hold. The periodic method of inventory management is variable in terms of quantity ordered but fixed in terms of timing.

    - Companies using this method establish reorder points that are a little higher than those used by companies that monitor inventory constantly. As a result, under the P-system, companies tend to carry a little more inventory. They also run the risk, however, of incurring prolonged stockouts when they're not on top of runs on inventory.

- Of the other two as-needed inventory strategies, one involves ordering in fixed quantities and the other allows for variable quantities. Using the fixed-quantity strategy, known as a *Q-system*, a company might order as needed in minimum order quantities imposed by the supplier, or the company might determine the quantities needed for itself. One common fixed-quantity approach is known as the *economic order quantity* (EOQ). This approach balances the annual cost of holding inventory and the annual administrative cost of processing orders.

- Ordering in fixed quantities, though, does not take advantage of the flexibility that companies seek today. That's why many have advanced to the fourth strategy, where neither the order quantity nor the timing of orders is fixed. This is a *just-in-time* (JIT) *strategy*.

- Rather than counting on large lots and infrequent ordering, JIT companies resort to small order sizes and high frequency. When demand is brisk, they increase either the batch size or the frequency, depending on costs. However, the focus is on keeping inventories low and replenishing only what's depleted when it's depleted.

- Companies often employ a *kanban* ("signboard") system to signal demand and the need for replenishment. The electronic versions of these systems are known as *e-kanbans*.

Choosing the Best Strategy

- As noted previously, most companies don't manage a single product but several different ones. The largest companies might have more than a million items to track and manage, and even a simple business can have an inventory of several hundred items. Clearly, this adds to the complexity of managing inventory and, often, the need to implement multiple inventory strategies.

- To address this complexity, most companies use some form of grouping for their inventory, such as an ABC classification scheme.
  - Under such a scheme, A items are those that sell in high volume, earn high margins, or are sold to the company's best customers; new products might also be labeled A items. These items are the ones for which the company tries to ensure ready availability. The company may be willing to take on a greater supply of A items to be certain that they're available; a stockout on these items could be detrimental to the company.

  - B items are of a somewhat lower priority and generally require a closer look to determine exactly how to manage them. If they're relatively new, "on the rise," or not expensive from a holding-cost standpoint, then a company might be willing to take on a greater supply. However, if these items are fading in popularity, easily substituted, or ordered by less important customers, then having a lower supply in inventory would be optimal.

    - Finally, C items are those that are on their way out. They may be unprofitable items, costly to keep, or on their way to becoming *dead stock*.

- Clearly, companies can create more complex classification schemes by simply adding letters to provide greater granularity. Also, a multi-letter scheme might be used to capture different dimensions. For example, a CBC item might be slow moving, marginally profitable, and sold to less valuable customers than a triple-A item.

Innovations in Inventory Management

- In light of the intense focus on inventory management in recent years, innovations present themselves frequently. One such innovation is the use of radio frequency identification (RFID) to track inventory as it flows through the supply chain. RFID technology comes in two basic types.
    - Active RFID involves attaching a small device to each product. The device has its own power source and emits a signal to indicate its location, enabling the product to be tracked. This technology is used in the transport of very large items, such as military armaments and shipping containers.

    - With passive RFID, the RFID tag can hold much more data than the traditional barcode, providing a unique identifier for that specific item and unit. With the added memory capacity, companies can track not only the unique identifier for that unit but also the production date, lot number, and special data, such as whether the good is hazardous or recyclable.

    - Electronic readers positioned at the inbound and outbound doors of facilities send energy to the passive RFID tag. This energy activates the tag, which sends a signal back to the reader with all of the data encoded in the tag. Because the whole process is automated, hundreds of items can be read at once. This compares favorably to traditional barcodes, which can be read only one at a time and often rely on people with handheld scanners to correctly scan each unit in and out of inventory.

- Another technological innovation that could affect inventory management dramatically is three-dimensional printing. Being able to create form-on-the-spot has tremendous implications for what companies stock in inventory and where they stock it. Among the more exciting developments is the prospective use of this technology in the production of on-demand medical devices and artificial body parts. Three-dimensional printing could alter our businesses, create new opportunities, and change the way we think about inventory.

Suggested Reading

Callioni, de Montgros, Slagmulder, Van Wassenhove, and Wright, "Inventory-Driven Costs."

Gruen and Corsten, "Stock-Outs Cause Walkouts."

Shepard, *RFID*.

Spear and Bowen, "Decoding the DNA of the Toyota Production System."

Waller and Esper, *The Definitive Guide to Inventory Management*.

Questions to Consider

1. What influences whether the holding of inventory is a blessing or a curse?

2. What are the problems raised by a stockout?

3. How do you rightsize inventory—that is, determine the right amount of inventory to hold? Is the rightsized inventory a moving target? Are there times and circumstances when you might be willing to hold more inventory?

4. Why do companies try to lighten their balance sheets of inventory toward the end of reporting periods (e.g., quarters, fiscal years)?

Managing Supply and Suppliers

Lecture 18

When most people think of purchasing, procurement, or supply management, they think of the department responsible for buying the "stuff"—raw materials, spare parts, and so on—that feeds the business. This function doesn't sound especially interesting until we consider the fact that supply management can render the company profitable or unprofitable based on the terms negotiated with suppliers; it also serves as the gatekeeper of quality. In this lecture, we'll explore how effective supply management practices can be leveraged not only to keep the business running but also to set it apart from others. We'll examine fundamental questions surrounding what to buy, how to select suppliers, and how to make good suppliers excited to get your company's business.

The Evolution of Supply Management

- The traditional role of the purchasing department in an organization was to acquire the necessary materials, goods, and services to feed the operation and to do so at the lowest possible prices. Over time, purchasing evolved into procurement, which expanded the set of purchasing activities and elevated the strategic focus of the tasks. Beyond merely "buying stuff," procurement professionals assessed the quality of competing suppliers and established supplier qualifications and material specifications.

- Over the past two decades, procurement has given way to modern supply management, which is even more strategic for the business and collaborative with suppliers. Supply management seeks to achieve competitive advantage by working effectively with choice suppliers, even engaging suppliers early in the development of new products and services. These days, supply management not only controls a considerable share of the company's budget, but it influences the competitiveness of the company through its connection with other business strategies and departments.

- One industry phenomenon that has accelerated the influence of supply management is the rampant adoption of outsourcing over the past three decades. As we've seen, companies are electing to outsource activities that they no longer view as their strengths, and with this decision, the role of supply management expands. Supply management usually assumes responsibility for selecting the outside suppliers, negotiating the arrangements, and monitoring the provision of services.

Centralized and Decentralized Supply Management

- Once a company determines what it will buy, the supply management organization can take shape. Critical to forming the organization is understanding the scope of the work required. If the company operates from multiple locations, how much responsibility will rest with a central purchasing organization and how much will rest with buyers at each location? Organizations opting for centralized control decide what to buy, select the suppliers, and initiate the orders, all from headquarters. Field personnel verify that the quantity and quality of supplies meet expectations but do not make strategic decisions.
    - The benefits of such a system include consolidating the spend and ensuring that the company achieves volume discounts from suppliers and high-priority service by virtue of putting large chunks of the business in the hands of fewer suppliers. Centralized control can also support greater standardization of supply across various field locations. The disadvantage of a centralized system is that it doesn't allow field operations to exert their influence on suppliers or to address their specific needs.

    - In contrast, decentralized control allows the field locations to act autonomously, to freely choose suppliers and to negotiate directly with them. Although the individual needs of the locations can be addressed in these arrangements, the volume of the spend may not be sufficiently large to warrant the most competitive price or highest-priority service from suppliers.

- Most good-sized companies pursue a blended strategy, which involves headquarters centralizing the planning of supply and field locations controlling the buying actions. Such arrangements try to achieve balance between the control of centralization and the flexibility of decentralization, though strategic decisions are left with headquarters.

Supplier Relationship Strategies

- A company's strategy for engaging suppliers is based in large part on what is purchased. Most companies must acquire "mission-critical" supplies—items that influence the quality of the products and services the company provides or that are visible to customers. The opposite of these visible and mission-critical items are the invisible, commodity items. Whereas a firm might emphasize quality with mission-critical items, price might be the highest priority with commodity items.

- The amount of attention directed toward supplier relationships also depends on how critical the supplies are to a company's products and services. A supplier of maintenance, repair, and operating supplies that don't go directly into a product typically doesn't warrant the same attention as a supplier that can help a company win or lose in the marketplace.

- How many suppliers of a given input is ideal? Competing theories weigh in on this question.
    - Some believe that fewer suppliers is better, even going so far as to recommend sole sourcing. The benefit of this approach is that the spend is concentrated in one place, which should elevate the volume discount. It's also easier to manage one supplier than several.

    - However, the dependency inherent in sole-sourcing arrangements drives many supply professionals away from pursuing them. Placing all of a company's business for a given input in the hands of a single supplier may eliminate the positive influences of competition on price and quality.

- Another school of thought on the ideal number of suppliers seeks to incite a feeding frenzy among multiple suppliers. The belief is that this situation intensifies competition and encourages suppliers to cut prices to the bone. This is usually a short-term proposition, however, because suppliers are interested in large chunks of business that are repetitive, allowing them to smooth their own operations and reduce transaction costs.

- Often a "middle-ground" strategy is preferred. Most progressive companies avoid sole sourcing where possible, yet they're not constantly on the prowl for new suppliers. Rather, they examine the portfolio of items and services they buy and look for opportunities to consolidate the spend, which will provide leverage in negotiations. They also look for opportunities to collaborate with suppliers of critical parts.

Selecting Suppliers

- It has become common for large supply management organizations to spend a preponderance of their time qualifying suppliers, that is, establishing standards for doing business with the company. In light of the vast interest in serving large companies, corporations use qualification as a way to filter the interest, requiring prospective suppliers to meet standards in quality, capacity, safety, and ethical performance.

- Once the qualifications are in place, a company can approach the supply market. Of course, the method of approach depends on both the company's situation and what it is buying. Seasoned buyers often know who to contact first—which suppliers have the capabilities, capacity, and pricing to be competitive. In some cases, a company might set up a reverse auction, inviting select players to compete in real time for the business and choosing the supplier that brings forward the lowest price.

- If simply putting the business out to bid and shopping for low price is not the answer, then companies may have to take an intermediate step to see what prospective suppliers have to offer.

This process involves “interviewing” suppliers through a request for information (RFI), a request for quote (RFQ), or a request for proposal (RFP).

Total Cost of Ownership

- In making supplier selections, most companies today are looking beyond purchase price. Instead, they’re considering what’s known as the *total cost of ownership* (TCO) associated with the purchase. This is a way of bringing a life-cycle perspective into the procurement of goods and services.

- The life-cycle perspective makes sense because TCO considers not only the purchase price but all the costs associated with acquisition, such as the costs of financing the purchase and preparing the business to use the materials or products. To that end, TCO also factors in the costs of use, including the cost of carrying inventory.

- But it’s in the determination of a product’s post-use factors that the life-cycle perspective of TCO can alter the landscape of the purchasing decision. These post-use factors include the costs of dissatisfied customers, such as warranty, recall, or liability costs, as well as the environmental impacts of products and packaging material in the post-use phase.

- In sum, the life-cycle perspective espoused in TCO revolutionizes the act of buying. It’s a 180-degee turn from traditional purchasing practice and requires much deeper thought than simply shopping for prices and specs ever accommodated.

Keeping Suppliers Engaged

- One tip for keeping suppliers engaged and working hard for your firm is to maintain open communications, especially with suppliers that are critical to your business. Invite suppliers to tour your facilities and request a tour of theirs. Seeing the products and services in use can inspire discussion and illuminate opportunities for improvement.

- You should also provide regular feedback to all strategic suppliers. Issue a monthly supplier scorecard, for instance, to rate performance on a few metrics that are important to your business and explain, in general, how the supplier is doing. The basic dimensions of performance usually include quality, cost, and delivery.

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Providing a scorecard for supplier performance should serve as a conversation starter, enabling both parties to see the potential for improvement and to develop a mutually beneficial relationship.

- Progressive companies also turn the mirror around and ask suppliers how satisfied they are with the focal firm as a customer. Such assessments usually examine the ease of doing business with the customer and are generally conducted by third parties.

- Leading-edge companies are also moving toward *supply chain competition*. Companies no longer compete merely head to head but also supply chain to supply chain, pitting their entire input-to-delivered-output systems against those of their rivals. With that in mind, there's a race to win the best, most innovative suppliers. These are the suppliers that possess unique intellectual property, processing capabilities, and branding to bolster your products and services.

- Beyond working with suppliers, you want to enlist them to help you compete. This can take the form of early supplier involvement, where suppliers help to devise the next generation of products and services. It may result in joint-venture opportunities or licensing

arrangements when the market proves promising. At a minimum, the involvement of suppliers early in the new product development process can highlight the limitations or challenges that you'll encounter should you elect to proceed with a bold new technology.

Suggested Reading

Ellram and Krause, "Robust Supplier Relationships."

Ellram and Siferd, "Purchasing: The Cornerstone of the Total Cost of Ownership Concept."

Monczka, Handfield, Giunipero, and Patterson, *Purchasing and Supply Chain Management*.

Tate, *The Definitive Guide to Supply Management and Procurement*.

Questions to Consider

1. How has supply management progressed beyond the tactical activity of buying?

2. Why is it important to engage other business functions in strategic conversations with suppliers?

3. What are the risks of having too few and too many suppliers of a critical input?

4. How does the lifecycle perspective of TCO change the orientation of a buying organization?

The Long Reach of Logistics
Lecture 19

Logistics is the business function responsible for ensuring that the right products are available in the right quantities at the right place and time to meet customer expectations. The field of logistics embraces the transportation and distribution of products, but it's something more: It's the overarching planning, timing, optimization, and coordination involved in getting products where they need to be, when they need to be there. In this lecture, we'll examine three key aspects of logistics: the role of logistics in providing the company's "reach" in the market through its chosen distribution strategy, the logistics network required to support the distribution strategy, and the operational aspects of logistics—the movement, storage, and technology used to meet customer requirements.

Distribution Strategies

- *Distribution* refers to the spreading of product throughout the marketplace so that a large number of people can buy it. It encompasses the warehousing, transportation, and tracking of goods into the marketplace, all of which requires strategy. We'll begin by considering three distribution strategies: intensive, exclusive, and selective.

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The business of logistics is substantial: About $1.4 trillion is spent each year in the United States alone to support the storage and transportation of goods.

- Some businesses, such as Coca-Cola or General Mills, aspire to have their products in the hands of every customer in a region or market. This is called *intensive distribution*. In order for these companies to earn sizeable profits on their narrow margins, they must sell tremendous volumes of their products. In essence, they use intensive distribution to "blanket the market" with their products.

- At the opposite extreme from intensive distribution is *exclusive distribution*. This strategy involves getting products in the hands of a limited number of people but offering a "high-touch" or customized buying experience. This approach is often associated with high-priced luxury goods, such as jewelry, fashion merchandise, and sports cars. Manufacturers that use exclusive distribution tightly control production and distribution. They either distribute the goods themselves or align with a limited number of distributors and retailers.

- The third strategy, *selective distribution*, fits somewhere between the intensive and exclusive distribution approaches. Companies pursuing selective distribution have more customers than exclusive providers and fewer than intensive competitors. Distribution might be selective in terms of the number and types of customers reached or in terms of the locations served.

- Depending on the desired intensity of the market coverage, any one of these three alternatives might support a company's competitive basis—how it intends to "win" in the market. And many companies employ multiple distribution strategies, using different approaches for different brands under the company's umbrella.

Logistics Networks

- The term *logistics networks* refers to the locations from which a business operates and the functions or purposes of those locations. Every business must consider the network over which it wants to conduct business such that it: (1) reaches customers with its products and (2) can access key sources of product supply. It's here we realize that logistics is involved in both the inbound and outbound sides of the business.

- Finding the right number and placement of locations involves not just science but art.
    - The art comes in the sense of importance that is imparted to customers by establishing a store or warehouse location near them or by setting up a convenient catalog or website ordering system.

    - Yet it's impossible to be located close to all customers when they're scattered about a large geographic area. This is where companies rely on science to figure out how to achieve the greatest reach with the fewest facilities. The goal here is the optimal blend of market access and cost containment.

- The science of logistics has its origins in military science, and commercial enterprises have borrowed the idea of the *center of gravity* from military strategists.
    - In the military, the center of gravity of an enemy is its concentration of forces in a conflict; it represents a source of vulnerability.

    - In business, the center of gravity represents the best place to locate a distribution point given the inbound supply and outbound distribution locations. It's the optimal point at which the total distance that must be covered in from supply locations and out to demand locations is minimized. To serve large markets, most businesses elect to operate from several locations.

- Competition can also fuel the need to increase the number of distribution and store locations. When a rival establishes a presence in a market, it creates a need to match the competitor's strategic move. Restaurant chains and retailers routinely demonstrate this behavior.

- Of course, there are a few checks on the logic of adding more locations to a logistics network. For instance, more facilities means a higher warehouse and real estate investment, and a company can expect to invest more in inventory as it adds distribution points in its network.

- It has been proven that a company will need more *safety stock* inventory when it adds locations to its network. Safety stock is the inventory held just in case there's an increase in demand or a delay in supply. This is opposed to *cycle stock*, which is inventory a company maintains to cover itself for forecasted sales and normal supply lead times. The greater the uncertainty a company faces, the more safety stock it requires.

- The *square root rule* predicts that the amount of safety stock a company holds will double when the number of locations quadruples. In other words, if a retailer increases its store count from one location to four, the safety stock inventory held across the four stores will be twice as much as when the company had a single location. This expected increase in inventory discourages companies from adding too many facilities to their networks.

- Transportation costs can also make adding too many distribution points unattractive. Adding locations means that a company also has to ship to those locations. Even though the company gets closer to customers on the outbound side of the business, inbound transportation costs can be prohibitive.

- The final check on the logic of adding locations to better serve a market is *cannibalization*. When sales flatten and saturation is achieved in the market, any sales gain for one location is accomplished at a loss to another location. Obviously, when the gain comes at the expense of a competitor, that's good. But when it comes at the expense of a company's partner locations, there may be little or no benefit.

- Determining the "right" number of locations is something of a moving target for many companies because markets are dynamic and logistics networks are fairly permanent or, at least, costly to change. To help accommodate the need to expand and contract logistics networks, some businesses seek the help of third-party logistics providers (3PLs), which own warehouse and transportation assets to help their clients expand and contract as needed.

- In lieu of outsourcing, some companies work with distributors and wholesalers to achieve broader coverage in a larger market than they could attain on their own. This practice is known as using indirect channels of distribution.
    - The obvious disadvantage to such arrangements is that the company loses direct touch with the end customer, who now buys from the intermediary.

    - In addition, the intermediary is likely to also sell products offered by competitors. Consequently, the manufacturer must try to appeal not only to the end customers but also to the intermediaries in the hopes that they'll stock and actively sell the firm's products.

Operational Factors

- Once a company has its distribution strategy and logistics network in place, it must turn to the operational side of logistics: delivering to customers or store locations. Here, the focus is on the *order cycle*, or *lead time*, which is the amount of time from order receipt to delivery. Much of the execution in this stage of the logistics process rests with transportation, which represents what is often called the "last mile" segment of the order cycle: the physical delivery of goods on time and safely to customers.

- Choosing the right means of transporting goods can have major cost and service implications for a company. Naturally, speed and dependability usually come at a higher price. It may cost 70% more to ship a product the next day to a customer than to use two-day delivery. There are five basic modes of transportation, each with its own cost and service implications: truck, rail, air, water, and pipeline.
    - Truck transportation is the most common means used today, given that it is so readily available and is generally regarded as fast and reliable.

  - Air transportation tends to be preferred for time-critical deliveries that must cover long distances, such as urgent cross-country or international shipments. High-value goods, such as consumer electronics and pharmaceuticals, often move by plane, as do highly perishable items (e.g., fresh-cut flowers) or products with short market life-cycles (e.g., fashion apparel).

  - Transportation by railroad is popular for shipments that allow for longer transit times over longer distances, such as hauling grains from Iowa to New York or coal from West Virginia to Arizona.

  - Transportation by water, including rivers, great lakes, and oceans, is preferred for the transport of massive quantities of goods when time is not critical and navigable waterways connect the origin and destination points.

  - Finally, pipeline transportation is currently limited to commodities that are fluid in nature, such as oil and gas.

- Sometimes, the best transportation solution involves combining modes for shipment in what's known as *intermodal transportation*. Although most items will move by truck at some point in their distribution, this mode of transportation can be expensive, energy intensive, and environmentally unsound. For these reasons, rail may be used more often in the future.

- The future could also be marked by new modes of transportation, such as the unmanned aerial drones—small programmable helicopters—that Amazon is experimenting with for home deliveries from order fulfillment centers. Experiments are also in place to test underground pipelines for shipping nonliquid cargo and blimps for moving large cargo over oceans.

- Advanced technologies in information systems are also influencing logistics activities. These technologies include transportation and warehouse management systems, as well as communicative technologies, such as the Internet, GPS, and RFID, used to link companies, enhance information exchange, and improve visibility of supply and demand across companies. In sum, there is immense change altering the logistics landscape and the means by which companies achieve "reach" in the market.

Suggested Reading

Arvis, Saslavsky, Ojala, Shepherd, Busch, and Raj, *Connecting to Compete 2014*.

Goldsby, Iyengar, and Rao, *The Definitive Guide to Transportation*.

McGoldrick and Barton, "High-Tech Ways to Keep Cupboards Full."

Murphy and Knemeyer, *Contemporary Logistics*.

Questions to Consider

1. How does effective logistics management affect a company's ability to compete?

2. Is logistics becoming more or less important in today's marketplace? Why?

3. Can you think of an example where poor logistics execution ruined your day?

Rethinking Your Business Processes

Lecture 20

Virtually everything we do involves a process, whether it's filing a legal brief, performing a surgical procedure, or making a product. But even though they go on all around us, we tend not to think deeply about processes or even notice them. In business, however, finding ways to improve processes has become indispensable to success. Companies use *process thinking* to determine what work really needs to get done and how to get the most of their available time and resources. This perspective focuses company efforts on the outcomes that create *defensible value*. In this lecture, we'll explore this concept and look at some simple tools for improving the processes that matter to your organization.

The Voice of the Customer and the Voice of Business

- It's often said that there are two voices we should listen to when making any business decision: the voice of the customer and the voice of the business. The voice of the customer tells us what customers are seeking in the way of product or service attributes and, more importantly, the outcomes they want to have fulfilled through the products and services they buy. Those outcomes, given a price the customers pay for them, render an assessment of value; therefore, *value* is defined as "quality given the price paid."

- Outcomes speak to the question: Does the product use or service experience satisfy—or better yet—delight the customer? To address outcomes, it's useful to take the time to listen to customers and understand their needs before engaging in a series of hit-and-miss "improvements" that might miss the mark!

- The voice-of-the-customer concept reminds us that the "right things" for a business to do should be in line with providing outcomes that customers want and are willing to pay for. This last piece—the "paying for"—brings in the voice of the business.

- This voice directs our attention to such needs as revenue, profitability, growth, image and stature, meaningful jobs for employees, and so on. In order for a business to survive and thrive, it must look after these needs.

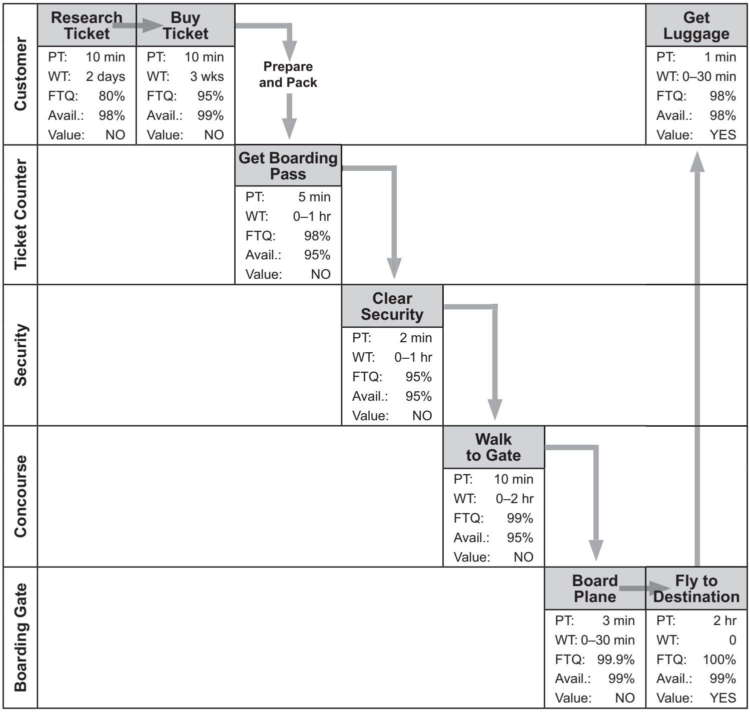
- Thus, the "right things" for the business to pursue are those that generate value in the eyes of customers and generate the business outcomes the organization needs.

Process Mapping

- Once you've figured out what outcomes to pursue—the "right things"—the next logical question is how to do these things "right," that is, how to achieve efficiency and effectiveness in the work processes performed. The first step here is to understand the current state of your processes, starting with those that are in clear need of help.

- The next step is to make the chosen process visual by capturing it in a *process map*. You can make this diagram using software or draw it out on a large sheet of paper or poster board. It's helpful to get the various people involved in the process to help you devise the map. The example on the following page is a process map for taking a trip by commercial airline.
  - The experience of taking an airline flight is captured here in eight steps: (1) researching the ticket, (2) buying the ticket, (3) getting the boarding pass, (4) clearing security, (5) walking to the gate, (6) boarding the plane, (7) riding out the flight, and (8) and collecting luggage. Limiting the process map to between 8 and 12 steps is usually good enough for a first pass; you can always add more detail later if you find a trouble spot requiring deeper analysis.

  - Note that step 4, acquiring the boarding pass and checking luggage, involves another party, the airline ticket agent. The involvement of other actors or locations in the process is delineated in a *swim lane*, an additional line of actions that



runs parallel to the main line. Each actor in the process has his or her own swim lane, as does each physical location. When the process moves from one actor to another, the transition is shown by drawing a line from one swim lane to another.

- The first pass at the process map does not mark the end of the review but, rather, the beginning. To the extent that others are involved in the process, you should confer with them to see if their version of the process jibes with yours and to discuss and resolve discrepancies. This discussion may reveal important misunderstandings or conflicts that stand in the way of process improvement.

Process Time, Wait Time, and Cycle Time

- Once agreement is reached on the first-pass map, it's a good time to reflect on the process as a whole, asking whether any steps or even the whole process could be eliminated. If you determine that the process remains essential, it's time to do a deeper analysis by populating the basic work steps with additional data, such as the amount of time required to complete each step (*process time*). You can also estimate the amount of time spent waiting within each step and between the various steps.

- In our air travel example, the sum of the process times across the eight steps is 161 minutes. Remember, this is the actual amount of time in which the actors in the process are engaged in work associated with booking the flight, reaching the plane, taking the flight, and collecting luggage. Of these 161 minutes, 120 are associated with the flight itself. The total wait time across the process is 23 days and 5 hours.

- The sum of the process and wait times is the *cycle time* for the process—the total time elapsed from process initiation to conclusion. In our example, the cycle time is 33,581 minutes. Note that the vast majority of cycle time is associated with the three-week period that elapsed between buying the ticket and taking the trip. Of the more than 33,000 minutes, only 161 involve actual work performed by the key actors in the process. This amounts to just under 0.5% of the total cycle time!

- The wait time for a flight might strike you as normal, but you might be surprised to learn that such a low level of time efficiency is common in both personal and business work processes. In fact, it's rare to find a measure of time efficiency greater than 10%. This speaks to the considerable slack time found in most processes. A process map helps to illuminate such wasted time.

First-Time Quality and Resource Availability

- Two other important factors to consider when analyzing processes are first-time quality (FTQ) and resource availability. *FTQ* refers to the percentage of time that a given work step is completed successfully on the first try. *Resource availability* refers to the percentage of time that the various resources required to perform a work step are available.

- The FTQ and availability levels for the whole process are calculated by multiplying together all the percentages for each factor.
    - In our scenario, the FTQ for the process is 68.6%. In other words, about 70% of the time everything about the flight process goes according to plan. The other 30% of the time, something goes wrong somewhere in the process.

    - Multiplying the availability percentages across the eight steps yields a total availability for the process of 79.9%.

- With the calculated totals for FTQ and availability in hand, look for the culprits that could affect these two outcomes to the greatest extent. In the case of FTQ in our scenario, researching the ticket (80% FTQ) is a major contributor to quality failure. Meanwhile, availability suffers somewhat at the ticket counter, the security checkpoint, and the departure gate—all locations where lines form and travelers must wait.

- Bear in mind that yields for FTQ and availability will only decline or, at best, sustain overall performance when more work steps are identified in a process. This is not only a mathematical reality of multiplying their values but also an operational reality. The more complicated a process becomes, the more opportunities for error, delay, and disruption are introduced. With that in mind, it's wise to try to simplify processes by reducing the number of steps involved. This, in fact, is a principle of Lean Thinking.

Labeling Work Steps

- To help in identifying which steps to eliminate from a process, Lean Thinking recommends assigning a subjective label to each work step. That subjective label is whether or not the step is a value-added one. In other words, does the step contribute defensible value to the process?

- If the elimination of a step would diminish the value of the process outcome in any way, it should be labeled "value added" and should remain intact in the process. In fact, you might explore ways in which you can add even more value through such a step. But if you can eliminate a step without interfering with the process, it should be labeled "non–value added."

- Note that some steps in the process may be non–value added but still necessary, such as observing laws and safety measures. These steps should be labeled "essential (or necessary) non–value added." Still, you should look for ways to reduce the time invested in these work steps.

- In our example, we might identify only two steps as value added: the air travel itself and collecting the luggage at the destination. In other words, travelers want to reach their destinations safely and find their suitcases on the baggage carousel; everything else in the process merely assists in making those outcomes possible.
    - These two value-added steps account for only 121 of the more than 33,000 minutes of the process; thus, the value-added time accounts for only 0.36% of the total cycle time. This low value is not out of the norm for such an analysis.

    - Unfortunately, the six non–value-added steps are essential to taking the trip, but ample opportunities for improved efficiency might still be found. For example, a traveler could use a smartphone to check in for the flight, streamlining the collection of the boarding pass. The point here is that all the steps in the process should be scrutinized for potential improvements.

- Adding the "value-added" and "non–value-added" labels converts the process map to a *value stream map*. This in-depth assessment of the current state of the process allows you to identify trouble spots or unnecessary steps in the process. You might also go a step further and create a *future state map* that adjusts the process to fit your vision. If the outcomes are commensurate with or exceed the value of the time, effort, and resources invested, then you can redefine how the work should be conducted in the future.

Suggested Reading

Dennis, *Lean Production Simplified*.

Garvin, "The Processes of Organization and Management."

Martichenko, *Everything I Know about Lean I Learned in First Grade*.

Rother and Shook, *Learning to See*.

Staats and Upton, "Lean Knowledge Work."

Questions to Consider

1. What is the value of visualizing a process by mapping it?

2. What should you take away from a process map that reveals that a process is performing at a throughput efficiency (ratio of value-added time to total cycle time) of less than 1%?

3. How should management address a situation where most of a person's work time is devoted to non–value-added work?

Measuring Operational Performance

Lecture 21

A performance measure is an expression of the health or vitality of an activity or process performed by an individual, a team, or an entire organization. Similar to measures of health for people, such as body temperature or pulse rate, business measures should be quantifiable—expressed in numbers. Metrics should also be precise and reliable; two people monitoring the same attribute should be able to arrive at the same reading. Finally, metrics should be easy to collect and understand, both effective and efficient in the information they convey. In this lecture, we'll look at some of the most meaningful measures to track in order to support your business.

The Balanced Scorecard

- Performance measures express the priorities of the organization and provide practical guidance for the work performed every day. Rewards and punishments are often based on how individuals perform against established, communicated standards. A good place to start when devising a performance measurement scheme is to reflect on your organization's vision and supporting strategies: What is it that you're trying to accomplish? What outcomes are you seeking, and what behaviors do you need from people to achieve them?

- In the 1990s, Robert Kaplan and David Norton devised a framework for performance measurement called the *balanced scorecard* that lays out four areas with which a company should concern itself for long-term growth and success: financial performance, customer assessment, internal business processes, and learning and growth. All four dimensions of the balanced scorecard are focused on the organization's vision and strategy.

Financial Performance

- Financial measures are absolutely essential for any business, and all companies use several of them. Among the most important financial metrics are measures of profitability, including profit margin

and operating margin. Others include measures of management effectiveness and measures taken from the company's income statement, balance sheet, and cash flow statement. These metrics provide meaningful insights from the perspective of shareholders and others with a financial interest in the company.

- From an operational standpoint, it's important to take a deeper look at the financials and try to interpret where your company may be overextended or lacking coverage in its operations.
  - For instance, you can divide the revenue figure from the income statement by the inventory figure found on the balance sheet. As we learned previously, this gives you inventory turns, a measure of the efficiency of your operations.

  - If you generate $100,000 in sales and you hold $20,000 worth of inventory, on average, you achieve 5 inventory turns (100,000/20,000). If you can generate the same $100,000 in sales with only $10,000 worth of inventory, on average, then you achieve 10 turns and can claim to be twice as efficient from an inventory standpoint.

  - Getting by with less inventory while still serving the customer well allows you to free up cash that can be used in other ways in the business. Retail organizations often use a similar measure for the efficiency of the company's salesforce by dividing sales by the number of employees to get a sales-per-employee metric. Again, the more sales you can generate with fewer employees, the more efficient your business.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When used in combination with other data points, financials can offer rich insights, both for those outside and inside a business.

- Finally, for publicly traded companies, the share price is considered to be the most efficient measure of financial health. The share price reflects the net present value of all future cash flows on a per-share basis and serves as a comprehensive measure of past, present, and anticipated future results.

Customer Assessment

- Customer satisfaction is the most common measure for the customer perspective of a business. To gauge it, marketers embrace a theory called the *expectancy-disconfirmation paradigm*. According to this theory, customer satisfaction is a result of the degree to which consumer expectations are either confirmed or disconfirmed by actual experiences with a product or service. When the perceived performance of a product or service meets or exceeds customer expectations, the customer is said to be satisfied. When perceived performance falls short of expectations, the customer is dissatisfied.

- Satisfied customers are believed to become loyal customers, who are often the most profitable segment for any business. Marketing to loyal customers costs less because they already know and like your company and its products and services; loyal customers tend to be resistant to the counterclaims of your competitors; they're often willing to be early adopters of new products and services; and they offer positive word-of-mouth endorsements to others.

- Companies measure customer satisfaction in different ways, but these measures almost always involve asking the customer how the business performed, usually following a specific transaction. Marketing researchers have learned that a single question offers a good read on satisfaction: "How satisfied were you with your recent experience?" More questions may be added to learn about specific aspects of the transaction. Answers are usually scored on a 5-point or 10-point scale to assess the relative degree of satisfaction.

- A metric called the *net promoter score* (NPS) is gaining a great deal of interest these days as a meaningful measure of satisfaction. Here again, one question is used: "How likely is it that you would recommend [our company] to a friend or colleague?" Customers respond on a scale of 0 to 10, and the NPS is calculated by subtracting the percentage of detractors (respondents showing scores of 0 to 6) from the percentage of promoters (those with scores of 9 or 10).

- Customer loyalty, as opposed to customer satisfaction, is best measured through actions rather than sentiments. Most telling is the percentage of repeat customers that your business enjoys. Still, it's important to continue asking customers about their levels of satisfaction and to keep monitoring behavior because customers' tastes and competitors' offerings can change over time.

- Interestingly, many companies today are trying to determine the cost of poor service, also known as the *cost of poor quality* (COPQ). This metric teeters on the financial side of the balanced scorecard but is squarely focused on the cost of disappointing customers. It asks: What is the lost revenue if we disappoint a customer and he or she returns or cancels an order?

Internal Business Processes

- The traditional metrics for business processes examine their productivity and efficiency. Productivity can be equated to the yield of a process. A process that generates a great deal of output is said to be a productive process. Efficiency, in contrast, looks at the amount of output given some level of input. A process that generates the same output as another but with fewer inputs is regarded as more efficient.

- More recently, the operational excellence philosophies of Lean Thinking and Six Sigma are yielding valuable insights on the management of business processes. In fact, they deemphasize the traditional focus on productivity and efficiency in favor of waste elimination and variation reduction.

- As we've said, Lean Thinking is the management philosophy that seeks to eliminate waste in its various forms throughout the business. The seven forms of waste are captured in the acronym TIM WOOD, which stands for transportation, inventory, motion, waiting, overproduction, overprocessing, and defects.

- As we've also seen, Six Sigma seeks to reduce variation. It relies on a five-step procedure for identifying improvement opportunities and seeing them through to implementation and sustained performance. The procedure is called the *DMAIC method*, for define, measure, analyze, improve, and control. The second phase of this method, *measure*, underscores the importance of assessing a process in its current state, as it undergoes improvement, and in sustaining improved performance.
    - A primary measure in the Six Sigma assessment is *defects per million opportunities* (DPMO). A *defect* is a work step that falls outside of established tolerances.

    - Six Sigma performance dictates an extremely low level of defects: 3.4 DPMO. The more defects found in a process, the lower the sigma level. A process performing at 1 sigma, for instance, allows more than 691,000 defects per million opportunities!

    - Highly automated manufacturing processes stand the best chance of achieving Six Sigma–level quality. Processes that rely more on human effort tend to have lower thresholds.

Learning and Growth

- The final dimension of the balanced scorecard framework is learning and growth. This perspective focuses on the knowledge and capabilities of the people that make up the business. This seems to be the least developed aspect of the framework, although concerted effort has been made in recent years to better understand what drives an employee and to align employees' interests and skills with the needs of the organization.

- The traditional focus of HR departments was recruiting new people into the organization and included such metrics as recruitment yield ratio, average time to fill a job vacancy, cost per hire, and employee turnover rate. Increasingly, however, HR departments are broadening their purview to include retention and the development of human capital. Measures in these areas might include voluntary and involuntary termination rates and average tenure.

- Metrics for employee development include training costs or investment per employee, hours of training, and employee assessments of satisfaction with training and development, as well as advancement opportunities within the organization.

- Both Lean Thinking and Six Sigma incorporate the human element in process achievement. Lean Thinking, in particular, brings a strong focus on safety and morale in the workplace. Common metrics here include days worked without a lost-time accident, number of reportable incidents, and near-misses. Closely related to safety is morale, which is often measured through a survey conducted by an outside party.

Sustainability

- A new frontier for performance measurement in business today is in the area of sustainability: the idea of operating a company so that it and the world around it both have healthy futures.

- Noted author John Elkington, in his book entitled *Cannibals with Forks*, prescribes a triple-bottom-line approach to measuring sustainable business performance.
    - The first bottom line is the economic one. As we've said, in order for any organization to thrive and survive, it must be able to sustain itself economically.

    - The second bottom line is dedicated to the environment. An organization that considers the long-term environmental consequences of its actions will be a better corporate citizen and a company that people want to buy from and invest in.

- The third bottom line is that associated with the societal impact of business activity—the question of how various people are affected by business activities. This bottom line seems to lag behind the other two, but it is important to devise appropriate metrics to guide decision making on this critical dimension of business endeavor.

Suggested Reading

Epstein and Buhovac, *Making Sustainability Work*.

Kaplan, Norton, and Rugelsjoen, "Managing Alliances with the Balanced Scorecard."

Kiron, Kruschwitz, Haanaes, and von Streng Velken, "Sustainability Nears a Tipping Point."

Peloza, Loock, Cerruti, and Muyot, "Sustainability: How Stakeholder Perceptions Differ from Corporate Reality."

Reichheld, "The Microeconomics of Customer Relationships."

Questions to Consider

1. What is meant by the expression "What gets measured, gets done"? How do performance measures influence behavior within an organization?

2. How does the balanced scorecard approach provide a 360-degree assessment of business health? Are there any aspects of business vitality that this measurement framework fails to address?

Keeping an Eye on Your Margins

Lecture 22

The gross margins of a business, which show the percentage of total sales that constitute profit, are fairly easy to calculate using the income statement. However, determining where the contributions to gross margin come from—in terms of products, services, and individual customers—is anything but routine. In fact, probably no more than 15% of companies determine profit contribution on a customer-by-customer basis. Instead, many just assume that all business is good. In this lecture, however, we'll pinpoint more precise numbers that show how different customers affect your business and force you to consume resources.

Customer-by-Customer Contribution Analysis

- In a start-up business, the relationship between how a business expends its resources and how it generates income may be fairly easy to see, but as the business grows, it may need a more advanced level of margin analysis. This analysis can be generated by product, product line, service, or customer. When examining customers, the focus is on the products and services that each customer buys.

- Consumer service organizations, retail businesses, and online retailers don't generally run a unique analysis for each customer. Instead, they look at types of customers and what these types typically ask for and buy in the way of products and services. This is what marketers call *segmenting the customer base*—breaking the market up into small groupings of customers that look and act alike in terms of what they demand and buy.

- With a business that sells to other businesses, however, the customer count is probably much lower; these firms sell larger volumes to a smaller number of customers. But very large business-to-business marketers may still have a customer count that numbers in the

thousands, which would also require some segmentation. In either scenario, business-to-business sellers should isolate their largest customers and segment the remaining ones.

- For most companies, the *80-20 rule* applies. This rule suggests that 80% of a company's revenues come from 20% of its customers. In other words, a relatively small number of customers is disproportionately important to the business in terms of how revenues are generated. These vital few customers that generate massive sales are the ones that call for individualized attention. Keep in mind, however, that your focus here should be on margin, not sales.

Differential Resource Consumption

- What really matters in a contribution analysis is reaching an understanding of *differential resource consumption*, that is, figuring out which customers force a business to consume what resources. To appreciate this idea, let's contrast it with traditional cost allocation methods, specifically, *average costing*. As its name implies, average costing simply divides a cost by the number of customers served to arrive at an average cost.
    - Consider, for instance, the cost of answering a customer's inquiry over the phone. The average cost method would simply look at all the costs associated with customer phone inquiries, including the cost of the call center facility, the phone lines, and employee time, and divide this sum by the number of inquiries made by customers.

    - But the average costing method is sorely lacking in accuracy and insights. It implies that all customer transactions are equally resource intensive, and often, that's not the case; not all customers consume resources equally.

    - However, when you rely on average costing to drive decisions, you're making that assumption: that service provisions consume resources equally across customers. As a result,

companies that rely on average costing are subsidizing their most taxing customers. In other words, customers that don't ask for much pick up part of the tab for demanding customers.

- This is a major problem because most companies assume that their biggest customers—the ones that generate the most revenue—are the best customers in terms of profit contribution. Yet many of these big customers can be fairly demanding to serve. And when you apply charges for the resources they force you to consume, you might find that these "big sales" customers are not the most profitable ones.

- Instead, when you focus on what activities you perform for which customers, you get a much richer understanding of how resources are consumed. As a result, you can be much more informed about how to dedicate your resources.

Cost-to-Serve Analysis

- A cost-to-serve analysis is one that expresses the cost of serving specific customers or, when that's not possible, the cost to serve different groups or types of customers who behave in a similar fashion. When you subtract the cost to serve a customer from revenue earned on the business, you arrive at the customer contribution.

- The first step in this analysis is to get a handle on business resources and expenses. Review the balance sheet for the resources and examine financial reports, such as the statement of cash flows and general ledger, to see how money is spent.

- Second, examine the activities performed in the business. In operations, the focus tends to be on the activities from order placement through delivery and collection of payment, such as order processing, production, fulfillment, and delivery. Of course, other activities that take place before the order and after payment, such as sales and marketing, can also be incorporated. The point here is to hone in on the activities that are unique or involve different types or levels of resource consumption across the different customers served.

- By linking the first step (related to resources) to the second step (related to activities), you can devise a cost per activity. The method used to translate resources to costs is borrowed from a technique called *activity-based costing* (ABC). As its name implies, ABC focuses on the activities a business performs and how these activities consume resources.

Activity-Based Costing

- An activity-based analysis typically focuses on one of two *cost objects*: products or customers. Thus, you can focus either on how resources are consumed to produce products and services or on how resources are consumed on a customer-by-customer basis.

- In linking resources to activities, it's helpful to generate a process map of the activities you perform for your customers. You can then link the resources (and ensuing costs) to each step in the process. What people and materials are involved, and how much of each goes into delivering the outcome of the activity?

- One way to simplify this analysis is to focus on a single *cost driver* for each activity—something that strongly influences the activity's cost. As the driver activity increases or decreases, the activity cost follows suit.
    - Consider the activity of delivering goods to customers. If your company delivers over long distances, such as across states, then distance may a good cost driver. But if you deliver locally (or in a small region), then time might be a better cost driver.

    - The determination of the proper or best driver is a judgment call and not always obvious. The goal is to strive for consensus rather than perfection in determining cost drivers.

    - Let's say that your company spent $20,000 on customer deliveries last month, including the cost of fuel, equipment maintenance, and personnel costs, and covered 10,000 miles.

Let's also say that the cost driver chosen for delivery expense is mileage. Dividing the $20,000 delivery expense by 10,000 yields a standard cost of $2.00 per mile for each delivery.

- ○ You would make similar calculations for the variety of activities performed in customer transactions to arrive at a cost for each activity, such as cost per order acquisition, production, invoicing, and so on.

- Finally, we arrive at the third step in the analysis: determining the cost to serve each of the customers and segments. Here, you need refer to existing records of how much activity goes toward each customer. What you'll find is that different customers demand different levels of activity. Each customer should be assigned costs only for the activities performed for that customer. This is a departure from average costing, where costs are assigned to customers irrespective of the specific service provision and activities performed.
  - ○ Suppose you deliver to a customer located 30 miles away (60 miles roundtrip). Applying the $2.00 per mile calculated earlier, each delivery to that customer costs $120.00. In contrast, a customer who picks up an order at your warehouse incurs no delivery costs.

  - ○ By marrying the cost per activity and activity level for each customer, you get the cost per activity for each customer. You can then sum up the costs across the various activities performed for each customer to arrive at the total cost to serve that customer per transaction.

- Two important points to keep in mind in conducting the cost-to-serve analysis are these: (1) Don't quibble about every penny in the analysis, and (2) include only the costs that would be eliminated if the cost object went away.

- ○ Going back to the delivery example, would you shut down the warehouse or reduce the size of the production facility if you lost a specific customer? The answer is probably not. Don't worry about how to split up the fixed costs of the facility when doing this analysis.

- ○ In essence, what that means is that you're conducting a contribution analysis instead of a fully loaded profit-and-loss analysis. You will still have to consider how to cover your facility and other fixed costs, but the contribution analysis will help you understand which customers are contributing to the coverage of these fixed costs.

Using the Analysis

- With this initial analysis, you can start to understand where your business is "winning" and "losing" on a customer-by-customer basis. What would you do, for instance, if you discovered that a sales transaction for which you charge a customer $300 per order actually costs you $350 to fulfill?

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Rewards programs and store loyalty memberships represent one approach to offering differential pricing in business-to-consumer marketing.

- One answer is to eliminate unprofitable customers, but that's not advisable unless you have other highly profitable customers waiting in the wings. A better solution is to make the underperforming customers profitable. The first option here might be to make internal changes that would allow you to perform the service more cost effectively.

- Another option, of course, is to raise prices to gain margins or to adjust the product or service. You could take these actions across the board, affecting all customers, or you could offer different products, services, and/or prices to different customers. This is an age-old practice in business-to-business marketing, where there is low transparency in the market in terms of what different customers receive and at what price.

- The insight you gain by comparing customer demands and resource consumption can allow you to move to a more menu-based arrangement for your products and services. That should ensure that every one of your business's transactions has a fair shot at profitability.

Suggested Reading

Cespedes, Dougherty, and Skinner, "How to Identify the Best Customers for Your Business."

Cooper and Kaplan, "Measure Costs Right."

———, "Profit Priorities from Activity-Based Costing."

Garrison, Noreen, and Brewer, *Managerial Accounting*.

Kaplan and Anderson, *Time-Driven Activity-Based Costing*.

Questions to Consider

1. Is it possible for your biggest customers (in terms of sales) not to be your best customers? How so?

2. How does activity-based costing differ from traditional average costing? In particular, how are the assumptions different?

Leveraging Your Supply Chain
Lecture 23

Among the most pervasive developments in business over the past few decades is the emergence of supply chain management (SCM), but there is much confusion surrounding the exact meaning of this term. It appears to involve a great deal of action—warehouses moving products along high-speed conveyors, giant cargo ships cruising the ocean—and extensive arrays of information technologies. That impression isn't entirely wrong, but a more complete understanding of SCM can illuminate why every organization needs to assess its supply chains to leverage the potential for competitive advantage. In this lecture, we'll look at the distinct discipline of SCM as a higher order of operations management.

Supply Chain Management as a Team Sport

- As you'll recall, a *supply chain* is the network of companies that works together to provide a good or service for the end-use market—individual consumers or businesses and institutions. SCM is the discipline of managing the network of suppliers and customers to achieve the greatest possible effectiveness for the benefit of your organization.

- It should be clear that for your organization to "win" in the long-term, it's essential to work with strong suppliers and customers. But it's also essential that those outside parties benefit from arrangements with your organization. In this sense, SCM should be considered a team sport.

- One example of this approach can be found in the efforts of Coca-Cola and Pepsi to develop an alternative to corn syrup as a sweetener for their soft drinks.
    - Coca-Cola worked closely with a major supplier of corn syrup, Cargill, to develop Truvia, a sweetener made from the stevia plant. Pepsi was also interested in the stevia plant, but because

Cargill was already spoken for, Pepsi had to find another partner. As a result, its competing product, PureVia, didn't reach the market until almost two years after Truvia.

    ○ What's interesting about this example is that it's not just a story about competition between two companies but about competition between their supply chains.

- Even Wall Street is catching on to the importance of SCM. A company's value is no longer tied merely to past performance and expectations for the future in terms of new products on the horizon. The relationships that the company forms with its strategic customers and suppliers also factor into its worth. A company with a better portfolio of customers or favorable relations with the best suppliers will be valued more highly than its competition.

- When you accept that SCM is a team sport, you've adopted what's called a *supply chain orientation*. A company with a supply chain orientation looks to leverage the capabilities and resource advantages offered by its outside partners in the supply chain.

Understanding the Network Structure

- The first step in leveraging your company's supply chain is to understand its network structure. From whom do you buy from, and to whom do you sell? The answers to these questions represent your tier-1, or immediate, suppliers and customers. A good idea is to map out this series of upstream and downstream relationships.

- Begin with your downstream customer relations. Are there some customers that are more important to your business? What share of your business goes toward these customers? As we've seen, it's quite common for 80% of a company's revenues to come from 20% of its customers.
    ○ Once you understand who your customers are and the volume and nature of the business you do with them, you should step back and think about how comfortable—or uncomfortable—that portfolio of customer relationships makes you feel.

- Are there customers on whom you feel overly dependent? Are there opportunities that appear to be left on the table? These are the relationships that call for more attention.

- With regard to those relationships on which you feel overly dependent, a simple yet powerful expression comes into play: $P_{AB} = D_{BA}$, in which P is power, D is dependence, and A and B are two independent parties. According to this expression, the power that A has over B is a function of how dependent B is upon A.
  - When one company is very dependent on another—in our equation, B is very dependent on A—then A can exert a great deal of power in its dealings with B. This can manifest in many ways: pricing and sales terms, delivery options, and so on. In extreme situations, the power imbalance can border on abusive relations; for example, a powerful customer might demand pricing concessions, unique services, and high levels of relationship-specific resources.

  - In these circumstances, it's essential for a company to understand its cost of doing business and to know when it must push back against a customer. Beyond mere resistance to egregious customer demands, the company can also step back and think creatively about how some sense of power balance can be achieved in the relationship. Can the company make itself indispensable to the customer in at least one category in which it competes for the customer's interest? Many small firms have been successful with this tactic.

- This equation of power and dependence also applies to relationships with suppliers. Your company should assess its relative position with suppliers, determine which suppliers are most important for the business, and figure out how to become the preferred customer to these critical suppliers.

- Research shows that the highest-performing business relationships are those in which there is a level of codependence. When the dependence goes only one way, then the powerful party will usually extract everything it can from the relationship, and the weaker party will be regarded as dispensable.

Forming Strategic Relationships

- It isn't possible—or advisable—to form strategic relationships with each of your customers and suppliers because such relationships require a great deal of investment. Forming a strategic relationship might involve dedicating a team of people with specific skill sets to an important account or dedicating a customer service line for the exclusive use of valuable customers. Certainly, not every customer warrants such an investment. The solution here comes down to a fundamental economic question: How can you best employ limited resources for the greatest benefit?

- When extensive investment is not possible or deemed worthwhile, you might dedicate a single individual to the account and be willing to offer some unique products and services. For your remaining customers, you should try to be easy to do business with, offering convenient store hours, an online presence, and customer service personnel, but you provide little in the way of customization or unique resource investment.

- Be especially careful when assessing the value of a customer relationship. If you rely solely on past sales, you might overlook tomorrow's stars. When the Solo Cup Company first had to decide whether to work with Starbucks, the coffee giant was a small, local operation with only seven stores. Had Solo passed on Starbucks' business at the time, it might not be the primary provider to the more than 18,000 Starbucks locations today.

- Use similar thinking when considering supplier relations. Some suppliers are more important than others and deserve extra attention. These might be suppliers that provide unique materials; offer higher

quality or better value; or possess intangibles, such as innovation in products and processes. There may also be troubled suppliers that are essential to your business yet are struggling with quality, cost, or delivery. These suppliers may deserve extra attention, too. The management of supplier relationships requires an understanding of which outside entities are poised to help you most—not only today but into the future.

Internal and External Integration

- The Global Supply Chain Form at Ohio State University has helped to define the field of SCM with a framework built on eight key business processes. The first two processes in this framework focus on rightsizing customer and supplier relationships: customer relationship management (CRM) and supplier relationship management (SRM).
  - The six additional processes are customer service management, demand management, manufacturing flow management, order fulfillment, product development and commercialization, and returns management.

  - Although CRM and SRM represent the key linkages in the supply chain, the other six processes represent the work that must take place across functions to create and transfer value through engagement in the supply chain network, especially with select suppliers and choice customers in the network.

- In case it's not already obvious, SCM should not be the work of a single department in a company, even though a company might have a department that has "supply chain" in its name. The Global Supply Chain Forum believes strongly that SCM requires the involvement of all business functions if an SCM team is to make the right decisions for a business, determine how to compete, and produce the greatest possible returns for the company and its shareholders.

- In this way, SCM is really a team sport on two levels: through internal integration, which requires coordinating all the functions within the company, and through external integration, which means leveraging business relationships with choice customers and select suppliers—figuring out how to go to market together.

- Small businesses have some advantage when it comes to internal integration. They can usually align themselves better and faster than their larger, more complex competitors. Decision making is usually more concentrated in smaller firms, and arguably, employees demonstrate a greater concern for the success of the business. Where there is better internal integration, the company is poised to realize the greatest benefits of integration with external partners.

- In contrast, large companies are often laden with bureaucracy that makes internal integration more challenging. However, they may find it easier to collaborate with outside companies because of their economic power and size. Large companies are also more likely to invest in integrative technologies and to dedicate teams of people to important business relationships that warrant the investment.

- Even though your company may not have fully dedicated suppliers or customers that promise not to buy from your competitors, SCM and the teamwork it involves can still be beneficial. The linkages in the supply chain network convey much more than product flowing from one company to another and cash flowing in the reverse direction. In some sense, participants in these networks are bound together and share a common identity … as if they're playing on the same team.

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The rewards for forming mutually beneficial relationships with the best suppliers and customers include improved economic returns, innovation, adaptability, and growth.

Suggested Reading

Fisher, "What Is the Right Supply Chain for Your Product?"

Lambert, *Supply Chain Management*.

Lambert and Knemeyer, "We're in This Together."

Lee, "The Triple-A Supply Chain."

Simchi-Levi, Clayton, and Raven, "When One Size Does Not Fit All."

Questions to Consider

1. Why is it important for a company to understand the supply chain network in which it operates?

2. What does it mean to say that there is equity in supply chain relations?

3. How can your restore balance in a supply chain relationship when the level of dependence is not in your favor?

Reducing Risk, Building Resilience

Lecture 24

Among the hottest topics in business today is risk management. Risks are found in situations with uncertain outcomes, and given the rate of change in the world today, our businesses are laden with uncertainty. The media is full of examples of companies that fail to take something into consideration—something for which they are held accountable or something that goes seriously wrong on their watch. Further, studies have shown that a "bad day" for a business, such as a delay in production or delivery, can result in a drop in the firm's stock price, on average, of 10%. In this lecture, we'll look at approaches for at least dampening the effects of potentially perilous situations.

Internal Risks

- The first step in risk management is to conduct a 360-degree scan of your organization or environment. In conducting such surveys, business strategists often use a *SWOT analysis*, examining strengths, weaknesses, opportunities, and threats. Strengths and weaknesses are assessments of the internal condition of the organization, while opportunities and threats are external to the company.

- Weaknesses represent the internal risks imposed on the business, many of which we've already explored: departmental conflict, an inattentiveness to mission, the inability to change, and complacency. Internal weaknesses can be among the most difficult to identify and measure. Symptoms may persist for quite some time before they result in a noticeable problem.
  - To aid in the recognition of symptoms before they become problems, many companies today use a tool called *failure mode and effects analysis* (FMEA), which helps to identify and prioritize risks.

- In this type of analysis, a *failure mode* is anything that could go wrong in a business—something that falls short of expectations or performance standards. A *failure effect* is an outcome or consequence of the failure mode.

- FMEA provides a scoring system for prioritizing the risk factors that call for the greatest attention.

- The first step in the FMEA process is to brainstorm across the range of failure modes. The range can run the gamut from everyday occurrences to the seemingly outlandish. The idea is to capture all the possibilities, which will be evaluated in the next step.

- After a failure mode is identified, concern is focused on three attributes associated with it: (1) probability of occurrence, (2) severity with occurrence, and (3) ability to detect occurrence. A simple subjective scoring system ranging from 1 to 10 is usually sufficient for evaluating these three attributes. The composite of the three scores is the *risk priority number* (RPN).
    - Imagine that a certain risk rates 10 across the board, meaning that it's highly probable, perhaps inevitable; is extremely severe when it occurs, perhaps resulting in fatalities; and is very difficult to detect at the time of occurrence. The RPN is this case would be: $10 \times 10 \times 10 = 1{,}000$.

    - The higher the RPN, the more the issue calls for immediate attention. Keep in mind that the objective is not to achieve 100% accuracy but to shine a light on the most significant risk factors.

- In addition to conducting FMEA, your organization can take additional internal steps to make itself more agile and resilient. For example, you can implement information technologies that make you aware of internal and external circumstances calling for attention. You should also establish a high level of communication across departments and functions to facilitate information sharing.

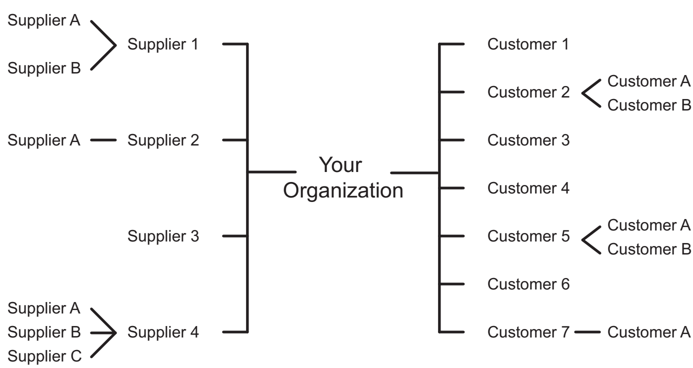
You can cross-train your employees to take on different roles and tasks, so that they're aware of each other's priorities and can fill in for each other in case of a crisis. Such steps can elevate your company's ability to sense and respond to challenges.

External Risks

- One of the most common sources of external risk is the supply chain. As you recall, the supply chain is the network of companies that work together to provide a good or service for the end-use market. Virtually every company exists within, and depends on, a network of companies to create and deliver value in the market. We all exist within this ecosystem of supply chains.

- Although outsourcing is common in many industries today, we've seen that it is not an effective strategy for pushing off risk, especially if it's your brand on the product or if you sell directly to end customers. Your company will be held accountable—if not in the judicial system, then in the court of public opinion—for any egregious act perpetrated in the provision of the product.

- When assessing opportunities and threats in light of this network orientation, it's wise to map the network, just as you would do in analyzing your company's internal processes. (See below.)



  - The first pass of the supply chain map is dedicated to simply identifying who makes up the chain, focusing on a single product or service offered by your organization. Suppliers that provide material inputs to support this offering are your immediate, or tier-1, suppliers. Where you might have many different suppliers of a given input, group them together. Alternatively, you might have one supplier that provides many different inputs.

  - Once you have a satisfactory diagram of tier-1 suppliers, add your tier-1 customers, those who buy this product or service from you. You may want to list important customers individually.

  - Next, see if you can identify tier-2 suppliers, those who support your tier-1 suppliers. They may be difficult to identify unless they brand their components or products. Connect the tier-2 suppliers to the appropriate tier-1s that they serve. For those you cannot identify, try to list the ingredient, component, or input that feeds your suppliers at the tier-1 level.

  - Next, list your tier-2 customers. Similar to tier-2 suppliers, these companies are likely to be more difficult to identify, especially if they're mass-market consumers.

- Once you have the map drawn out, step back and take a critical look at it. Who are your most critical suppliers and most valuable customers? Where are you most dependent in your relationships or even overly dependent?
  - You might find yourself overly dependent on one or a few key customers. If one customer represents more than 20% or 25% of your sales, that's a sign that you should diversify your customer portfolio.

  - You want to be able to direct your capacity toward the best-paying opportunities, but you don't want to be overly dependent on one or a few key customers. That situation puts you in a weak bargaining position. At a minimum, you want to engender a level of codependency in these arrangements.

- Likewise, you may be overly dependent on one or more suppliers, on individual ingredients that go into your products, or on the locations that supply them.
    - Consider the case of rare-earth minerals, metals that are used extensively in advanced consumer and industrial technologies. These minerals are difficult to extract from the earth and rather dirty and costly to process. Environmental regulations in the United States have made it economically unviable to mine these materials here.

    - As a result, the world has become dependent on suppliers in China, where environmental laws are not so stringently enforced. It's estimated that even though China is endowed with about half of the world's natural supply of these rare-earth minerals, Chinese companies supply about 96% of the world market.

    - This realization puts manufacturers of technological products ill at ease. Do they want to be so dependent on one nation for supply? This can be especially problematic when a foreign government elects to impose tariffs and quotas, dramatically altering the availability and price of supply. Alert companies are determined to engineer these materials out of their products. Clearly, this calls for a cross-functional team to identify different materials that might serve the purpose of the original ingredient.

- Other instances calling for awareness of the reach of supply chains can come from state, national, and international regulatory requirements. For example, the California Transparency in Supply Chains Act of 2010 requires large retailers and manufacturers doing business in California to disclose their efforts to eradicate slavery and human trafficking from their direct supply chains for all the goods they offer for sale.

- Where you have difficulty mapping critical supplies and customers, it illuminates a need for understanding and, possibly, greater controls. For example, one finding that is quite common in supply chain mapping is the revelation of common sources of supply at the tier-2 level.
    - In an effort to avoid overdependence at the tier-1 level, you might buy from two or more tier-1 providers of the same input. Yet when mapped beyond tier-1, the supply chain might show that your tier-1 suppliers are buying from the same supplier at tier 2.

    - Therefore, if disruption occurs with the tier-2 supplier, all your tier-1 suppliers of this item could be paralyzed, making you as vulnerable as if you had only one tier-1 supplier. This circumstance is uncovered only if you can map your supply chain beyond the tier-1 level.

Environmental Risks

- Along with mapping your supply chain, it's a good idea to do a 360-degree scan of your environment to identify risk factors other than those residing with suppliers and customers. These include the risks that competitors can present, risks found in the markets and economies in which you operate, or risks that may be introduced by social change or government actions. The FMEA tool can be helpful in conducting this external assessment and prioritization of risks.

- By brainstorming, you can identify a diverse array of risks, everything from everyday occurrences to the extremely rare. The military characterization of events as known-knowns, known-unknowns, and unknown-unknowns can be helpful here. Known-knowns are events that have some precedent and might even be explained or predicted. Known-unknowns are events that have been identified but happen rarely and, hence, have little supporting data. Unknown-unknowns are events that can only be imagined, having no recorded history.

- When you brainstorm about your company's risks, you may discover some that are interdependent. You might find, for instance, that by eliminating one risk, you elevate or introduce another. One risk common to all businesses is a stockout, and one way to address this risk is to hold large quantities of inventory. Yet inventory comes with a cost; thus, by reducing one risk, you elevate another. The name of the game in risk management is usually to offset an unacceptable risk with a more acceptable one.

- Once you have a strategy for embracing challenges, try to form strategic relations with your most critical suppliers and prized customers. Such connections enable you to mitigate risks and make it difficult for competitors to emulate your success in good times and bad.

Suggested Reading

Driscoll, "Why Companies Keep Getting Blind-Sided by Risk."

Gardner and Cooper, "Strategic Supply Chain Mapping Approaches."

Reeves and Deimler, "Adaptability."

Sáenz and Revilla, "Creating More Resilient Supply Chains."

Sheffi and Rice Jr., "A Supply Chain View of the Resilient Enterprise."

Simchi-Levi, Schmidt, and Wei, "From Superstorms to Factory Fires."

Questions to Consider

1. Is it possible to eliminate the risks that a business faces?

2. What is a failure mode? How can FMEA be used to manage risks in business?

3. What can a company expect to learn from a supply chain map as it relates to vulnerabilities and risks?

Critical Business Skills: Finance and Accounting

Eric Sussman, M.B.A.

Critical Business Skills: Finance and Accounting

Scope:

Accounting and finance are two of the cornerstones of any business school curriculum—and for good reason. Accounting, often called the language of business, provides the means by which organizations communicate—in facts and figures—how effectively they are fulfilling their strategic missions and operating objectives by providing critical information to current and prospective investors, creditors, and regulators. Accounting rules and standards provide the framework by which individual transactions are recorded in financial records and consolidated into financial statements, including the income statement, balance sheet, and statement of cash flows.

Finance is all about decision making—how accounting information, financial statements, and economic data are used by individual investors, business owners, and corporate finance personnel to decide whether to make a particular investment; how to raise capital needed to run or expand operations and the trade-offs of each; how to value stocks, bonds, or other cash-producing assets and optimally place them in a diversified portfolio; and how to more appropriately assess the relationship between risk and return.

These 12 lectures are designed to summarize and present critical theories, vocabulary, and real-world applications from both disciplines. The overall goal of this section of the course is to help you make better and more informed investment decisions, whether you are an individual investor seeking to understand how the companies you're interested in are performing, a business owner seeking to improve your accounting and finance skill set or to more effectively interact with and manage accounting and finance staff, or simply someone who wants to further his or her business education.

This section of the course is structured in two parts. The first six lectures focus on key issues in accounting to enable you to become a more informed reader of financial statements and accounting information released by companies in which you might have an interest. In Lecture 25, we introduce

generally accepted accounting principles, the primary standards under which most U.S. companies account for, record, and consolidate transactions into their financial statements.

In Lectures 26 through 28, we analyze the income statement, balance sheet, and statement of cash flows in depth, introducing key accounting definitions along the way. In Lecture 29, we discuss ratio analysis, a useful tool that allows us to use financial statements to evaluate an organization's profitability, efficiency, liquidity, and risk, while allowing comparisons to other organizations, including competitors. Finally, in Lecture 30, we discuss breakeven analysis and introduce the concept of contribution margin.

The second six lectures focus on key concepts in finance: the time value of money and how to discount future cash flows to their present-value equivalents, how to think more formally about the relationship between risk and return, and the trade-offs for firms deciding whether to use debt or stock to finance their businesses. Along the way, we will introduce important finance terms, such as net present value and the internal rate of return, common measures used to evaluate investment opportunities. Finally, we will discuss how to value stocks.

These lectures are designed not only to introduce you to the theoretical concepts in both accounting and finance but to provide practical and concrete examples for applying both disciplines in your everyday life. ■

Accounting and Finance—Decision-Making Tools

Lecture 25

The year 2008 was one most investors would like to forget. The investment bank Bear Stearns was sold at a fire-sale price to J.P. Morgan in March 2008. Then, Lehman Brothers filed for the largest bankruptcy in U.S. history. The country faced its greatest financial crisis since the Great Depression. Many people have since asked whether these events were foreseeable, and an examination of Lehman Brothers' financial statements from 2007 clearly reflects the likelihood that the company would fail. One lesson we can learn from these failures is that it is our job to understand the accounting and financial reporting issues of the companies in which we invest. In this section of the course, we will tackle that task.

Defining Terms

- Accounting is the language of business. It's an important means by which organizations communicate to key constituents—in facts and figures—how they are performing and how effectively they are fulfilling their strategic goals and objectives.
  - The key constituents within and external to any organization include employees, management, clients and customers, shareholders, lenders and creditors, members of the board of directors, and even taxing authorities. All these constituents have an interest in the financial performance of organizations with which they are invested or involved.

  - Employees, managers, and executives need to plan and control operations, manage resources, evaluate capital needs, and make important strategic decisions. Investors and creditors, including trade suppliers and lenders, must evaluate the company's financial strength and performance to know whether to lend or invest capital in the organization.

- How do these constituents make their decisions and evaluations? The answer is through accounting data. These data tell stories that are crucial to understanding the overall fitness of a company. In fact, if you review the financial statements of any organization, you should be able to discern a tremendous amount of information about it, including its profitability, the effectiveness of its asset management, how it is funded, and more.

- Finance puts the language—the stories—of accounting to practical use. It focuses on how accounting information is used to make certain decisions. These decisions might include whether a particular investment opportunity makes sense and should be pursued; how best to raise capital needed to run or expand operations; how to value stocks, bonds, or cash-flow-producing investments; and so on.

Standard Accounting Disclosures

- Companies are required to provide annual reports to shareholders, and in the United States, they file the equivalent, a Form 10-K, with the Securities and Exchange Commission (SEC), generally within 60 to 75 days after the end of the fiscal year. Annual reports must include an overview of the company's business and operations, discussion and analysis of financial results, financial statements and related footnotes, an independent audit report, and several other disclosures. The four financial statements disclosed in annual reports are the balance sheet, income statement, statement of cash flows, and statement of shareholders' equity.

- The balance sheet is often called the statement of financial position; it details what an organization owns—its assets—and what it owes—its liabilities and debts. All the information on the balance sheet is as of a particular point in time, typically the end of a fiscal quarter or year.
    - If assets exceed liabilities on the balance sheet, the difference is called *shareholders' equity*. If liabilities exceed assets, the difference is called a *shareholder deficit*.

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In addition to public companies, many other organizations, including municipalities, nonprofits, and some private firms, must also prepare annual and audited financial statements.

  - The balance sheet helps tell us how liquid an organization is, how much it has invested in working capital (for example, inventory and accounts receivable), how much debt it has, and therefore, how leveraged or risky it appears to be.

- The second financial statement is the income statement, often called the statement of operations, the profit and loss statement, or the statement of revenues and expenses. It includes such key metrics as revenues, net income, and earnings per share.
  - Unlike the balance sheet, which is prepared as of a particular point in time, the income statement reflects operations during a particular period of time, typically a quarter or a year. It starts with revenues, subtracts costs and expenses, and ends with net income or loss (or net surplus or deficit for nonprofit organizations). The income statement is the accountant's best effort at measuring the economic performance of an organization during a given period of time.

- Although the income statement tells us about an organization's profit or losses, it does not tell us about the organization's actual cash flows. That is, we cannot look at an organization's income statement and discern whether it is generating or bleeding cash. The reason the income statement doesn't give us that information is that it is required to be prepared using the method of accrual accounting, rather than cash-based accounting.

- Under the rules of accrual accounting, a company is allowed to recognize revenue from a sale as soon as it delivers its products to a customer, whether or not the company actually receives cash from the sale at the time of delivery. Thus, any company that complies with generally accepted accounting principles (GAAP) will report profits or losses on its income statement that differ from cash flows, and these differences can be material.

- As a result, organizations must also provide another kind of financial statement, the statement of cash flows. This statement reports, for a certain period of time, the amount of actual cash either generated or consumed by an organization. As we will discuss, the statement of cash flows provides two key pieces of data for users of financial statements.
  - First, it lays out the differences between reported profits or losses under accrual accounting and the actual cash inflows or outflows of the organization during that same period. Second, it segments the cash flows into three distinct categories: those from operating activities, investing activities, and financing activities.

  - Operating activities are supposed to reflect cash inflows or outflows from normal and recurring operations. Investing activities should capture the cash inflows or outflows from a company making nonrecurring investment decisions, including the purchase of property, plant, or equipment; mergers and acquisitions; or even the investment of excess cash into stocks

and bonds. Financing activities should reflect cash inflows and outflows from transactions involving a company's lenders and shareholders, such as the issuance of stock or bonds, the payment of dividends, or the repurchase of company stock.

    - The statement of cash flows is extremely important because it tends to be the most objective of the financial statements. It also serves as a crucial link to valuation.

Accounting Myths

- Many people seem to believe that because accounting involves so many numbers and figures and is rule based, it must be scientific and objective. Unfortunately, that isn't the case. In fact, there are a number of estimates that pervade financial statements, and plenty of judgment and subjectivity are involved in applying particular accounting rules.

- In addition, people often assume that there is one most important figure—revenues, net income, or some other metric—that investors and others should look at to evaluate financial performance. Unfortunately, there is no single measure that allows an overall assessment of financial performance. Some metrics or disclosures might be more important than others, but it is crucial to take a holistic approach to analyzing financial statements.

- Another myth regarding accounting is that companies should have only one set of accounting records. Having more than one set of books might sound like fraud, but in fact, it's business as usual. For example, most organizations have at least two sets of accounting records, one for creditors, lenders, and shareholders, and the other for tax authorities.
    - The rules concerning how transactions are reported to shareholders and how they are reported in tax returns are not the same. For example, firms can report one set of profits to shareholders and another, much lower, set to tax authorities. This may not be surprising given that tax authorities and accounting regulators do not have identical objectives.

  - For instance, in 2013, Apple reported pretax earnings of $50.2 billion to shareholders; on that level of earnings, Apple paid $13.1 billion in taxes. That represents only 26.3% of pretax profits, far lower than the top federal tax rate of 35%.

  - The company obviously took advantage of various tax loopholes and rules to avoid paying some taxes. There is absolutely nothing inherently illegal or improper about that, and in fact, Apple's CEO, Timothy Cook, has testified before Congress on this issue, stating that the company was complying with tax laws and taking advantage of the rules as written. The important thing for us to keep in mind is that the Financial Accounting Standards Board and the Internal Revenue Service often do not see eye to eye.

- Finally, it's not true that the financial statements tell us how much a company or organization is actually worth. For example, the balance sheet may indicate what a firm owns and owes, but most assets are not reported at their fair market values. Further, some valuable assets—particularly intangible assets, such as patents, trademarks, and copyrights—might be omitted from the balance sheet entirely.
  - Consider, for instance, the Apple logo, the Coca-Cola brand name, or Mickey Mouse. Obviously, these are three of the most valuable intangible assets in the world, each worth billions of dollars. Their owners generate significant profits and cash flows from them, but these assets are not recorded on the financial statements of the companies that own them.

  - The problem here is that there is no truly objective means of valuing these intangible assets; for this reason, accountants have decided not to record them on financial statements. Thus, to estimate the value of a company, we need to use the available accounting information and make appropriate assumptions and adjustments.

- As we move forward in these lectures, we'll explore even more of the interesting and informative analyses we can perform by applying some fundamental lessons in accounting and finance, with the goal of improving our financial decision making in business and in life.

Suggested Reading

Collins, Johnson, Mittelstaedt, Revsine, and Soffer, *Financial Reporting and Analysis*, chapters 1–2.

Easton, McAnally, Sommers, and Zhang, *Financial Statement Analysis and Valuation*, chapter 1.

Questions to Consider

1. Why do you think the regulators, including the SEC and the Federal Reserve, missed the clear indications of risk evident in the financial statements of Lehman Brothers, Bear Stearns, and AIG?

2. Pick a publicly held company you currently own stock in, have owned stock in sometime in the past, or are contemplating investing in sometime in the near future. Find the company's most recent annual report or Form 10-K on its website (generally in the investor relations section). Open up the document and see if you can find the company's five financial statements. Take a look at the income statement and determine whether the company reported a net profit or loss in the most recent year.

How to Interpret a Balance Sheet

Lecture 26

In the last lecture, we introduced some key concepts in accounting and finance and explained why these disciplines are critically important topics that all investors and businesspeople should understand. In this lecture, we will take a deeper dive into the balance sheet, the financial statement that details what an organization owns and what it owes as of a particular point in time, typically, the end of a quarter or year. The balance sheet is important because it provides clues about an organization's financial stability, its risk, and its liquidity, that is, its ability to meet its short- and long-term financial obligations.

Balance Sheet Overview

- As most of us know, Intel is a manufacturer of microprocessors, chips, and other products used in various technology applications. Its consolidated balance sheet, along with its other financial statements, can be found on the company's website, in the investor relations section.

- Intel's 2013 balance sheet presents two reporting periods, one ending December 2013 and one ending December 2012. This is typical for all organizations and lets us compare numbers over time. Note, too, that all the figures on Intel's balance sheet are presented in millions.

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Even individual households should have a sense of their assets and debts to optimally manage their finances, invest appropriately, and plan for the future.

- On the balance sheet, Intel's assets are listed first, followed by liabilities and stockholders' equity. Remember that stockholders' equity is the difference between the total amount of assets and the total amount of liabilities. By definition, therefore, assets must equal the sum of liabilities and shareholders' equity. The relatively simple formula Assets = Liabilities + Equity is sometimes called the *basic accounting equation*.

- Finally, note that the assets and liabilities are divided into two distinct categories: current and noncurrent. The dividing line between current and noncurrent on any balance sheet is 12 months.
    - Thus, a current asset is something that is liquid, something that can or will be used within 12 months. On Intel's 2013 balance sheet, the current accounts receivable is $3.582 billion. That's the amount owed by Intel's customers that is expected to be collected within 12 months following the date of the balance sheet.

    - Similarly, the current liabilities are amounts that Intel expected to pay to others during the 12 months following December 31, 2013. Specifically, Intel owed $2.969 billion to its vendors and suppliers as of the end of 2013, which it expected to pay before the end of 2014.

    - By definition, then, any items below "Current assets" are things that are expected to last longer than a year, and items below "Current liabilities" are amounts expected to be paid after a year. Examples of noncurrent assets would include property, plant, and equipment—the fixed assets of any organization—while an example of a noncurrent liability would be long-term debt.

Current Assets

- On the asset side of the balance sheet, assets are ordered from the most liquid to the least liquid, starting with current assets. Thus, on almost every balance sheet, the first asset to appear under "Current assets" is cash and cash equivalents.

- Cash equivalents are essentially any risk-free securities with a maturity date of less than 90 days. Examples might include money market accounts, a three-month certificate of deposit from a bank, or a U.S. treasury bill.

- Clearly, the cash balance is important because it gives us a sense of how much cash the organization has at the end of the reporting period and, of course, how that balance compares to the prior year.

- Other assets that typically make up current assets include marketable securities—any stocks, bonds, or other liquid investments the organization might own. The sum of the cash, cash equivalents, and marketable securities gives a sense of the liquidity of an organization. Different organizations label these marketable securities differently in their balance sheets. Intel, for example, refers to them as "Short-term investments."

- Accounts receivable—amounts owed to the company by its customers—typically follow marketable securities on the balance sheet.
  - As mentioned, Intel's balance of accounts receivable at the end of 2013 was about $3.6 billion. On the company's balance sheet, a note about this amount reads: "net of an allowance for doubtful accounts" of $38 million. This is an important disclosure.

  - It makes sense that some customers that owe Intel money may not pay. In fact, there are very few firms—perhaps none—that collect all amounts they are owed from their customers. Therefore, under GAAP, organizations must make an estimate of how much of the total receivables they are owed that will not be collected. Intel estimates that it will not collect $38 million on some $3.6 billion of receivables, a little more than 1%.

  - This allowance for doubtful accounts is a subjective estimate. Presumably, the company has looked at its collection history and the details of its receivables—who owes what and how

long the receivables have been outstanding—to determine what it believes should be the allowance for doubtful accounts, but this amount is only an estimate made by management.

    - In some cases, management might be motivated to misstate the allowance for doubtful accounts. For example, if a company understated this allowance, its reported profits or earnings and its reported earnings per share would be overstated. Thus, we need to take a close look at this estimate for all reported periods to be sure that the figures appear consistent.

- It's also important to look closely at the change in accounts receivable from one year to the next.
    - Remember that accounts receivable represent sales of products or services for which the organization has reported the revenue, income, and earnings but has not yet received the cash.

    - Imagine a situation in which a company is very liberal with its credit terms, allowing customers to take delivery of products and to make installment payments over an extended period of time. Obviously, this could create a problem if the customers ultimately don't make the payments. In short, accounts receivable are valuable only if a company collects them!

    - Thus, we need to pay close attention to the accounts receivable balance, changes in the balances over the years presented, and the allowance for doubtful accounts the company has recorded as a reserve against those receivables.

- Typically, the last current asset listed on a balance sheet is "Other assets." To find out what these other assets are, we generally need to look at the accompanying footnotes.

Long-Term Assets

- The category "Property, plant, and equipment" usually makes up the bulk of a company's longer-term or noncurrent assets. Intel's balance of fixed assets is more than $31.4 billion.

- The principal issues with respect to any organizations' fixed assets are threefold. First, what should be considered a fixed asset—something that should be reported as an asset on the balance sheet, as opposed to just accounted for as a normal and recurring expense?
    - For example, if you repair a leak in the roof of a building, is that routine maintenance that should be expensed immediately, or should it be considered part of the building and recorded on the balance sheet as an asset? Obviously, there is some judgment involved here about whether a particular repair really adds to the useful life of an asset or not.

    - However, this simple concept was part of the largest accounting fraud in history, one perpetrated by MCI WorldCom, in which the company improperly treated some $10 billion of normal and recurring expenses as fixed assets on its balance sheet. The result was a significant overstatement of reported profits and assets on the balance sheet. The company ultimately filed for bankruptcy, and its top two executives went to jail for accounting and shareholder fraud.

- A second question related to an organization's fixed assets is: How are they valued on the balance sheet? Is the value based on what the company paid to purchase them, their worth as of the date of the balance sheet, or something else?
    - All fixed assets are accounted for in a unique manner. They are recorded on the balance sheet at their original or historical cost, then depreciated over time. This is true whether the fixed asset is actually something that depreciates, such as machinery and equipment, or the company headquarters or other pieces of real estate that the organization might own, which would generally be expected to increase in value over time.

    - In fact, some organizations own a great deal of real estate, and because of the depreciation rules, these assets may be significantly undervalued on their balance sheets.

- The final consideration regarding fixed assets is how much, on average, the organization spends each year on fixed assets, commonly called *capital expenditures* (CAPEXs). As we'll see in a later lecture, CAPEX estimates are important to investors who want to value companies and stocks.

- Unlike fixed assets, which are clearly tangible, intangible assets do not have any physical characteristics. These assets include goodwill, brand names, trademarks, copyrights, and patents. Generally speaking, organizations report only the intangible assets they have acquired from another firm, usually as part of merger or acquisition activity.

Liabilities

- Current liabilities include any amounts the organization expects to pay within the next 12 months. One quick test to assess an organization's liquidity is to check that the balance of current assets is greater than current liabilities.

- However, in order to better gauge an organization's risk of insolvency, we also need to closely examine long-term debt, that is, the amount the company has borrowed that is due to be repaid beyond 12 months. Note that we don't know the exact maturity date for long-term debt, and this can make a significant difference in the soundness of an organization's finances.
    - For example, at the end of 2008, American Airlines had about \$8.4 billion of long-term debt, some \$6.3 billion of which was due before the end of 2012—not very long-term. Obviously, the financial crisis of 2008 hit the airlines hard. American Airlines could not repay or refinance all its debt and filed for bankruptcy in late 2011.

    - It is imperative to review the footnote in the financial statements that deals with long-term debt. This footnote will give a clearer picture about when the long-term debt actually comes due.

- Finally, we should note that some debt a company has might not be listed on the balance sheet at all. The most common example of this off–balance sheet debt is operating leases. Companies that lease most of their stores don't list the value of these long-term leases on their balance sheets as long-term debt. We'll revisit this fact later when we discuss valuation.

Suggested Reading

Collins, Johnson, Mittelstaedt, Revsine, and Soffer, *Financial Reporting and Analysis*, chapter 4.

Easton, McAnally, Sommers, and Zhang, *Financial Statement Analysis and Valuation*, chapters 2, 5.

Kieso, Weygandt, and Warfield, *Intermediate Accounting*, chapter 5.

Questions to Consider

1. Using the balance sheet from the company you selected at the end of the last lecture, determine the amount of total current assets owned by the company at the end of the most recent fiscal year. How does it compare to the balance of current liabilities? What is the difference?

2. Again, using that same company balance sheet, what is the total balance of long-term debt, if any? How has the balance changed from one year to the next? Finally, review the long-term debt footnote following the financial statements and determine when the company's long-term debt is due. How much is due in the next three years? How much thereafter?

Consolidated Balance Sheet: Intel

December 28, 2013 and December 29, 2012 (In Millions, Except Par Value)	2013	2012
Assets		
Current assets:		
Cash and cash equivalents	$ 5,674	$ 8,478
Short-term investments	5,972	3,999
…		
Accounts receivable, net of allowance for doubtful accounts of $38 ($38 in 2012)	3,582	3,833
…		
Other current assets	1,649	2,512
Total current assets	32,084	31,358
Property, plant and equipment, net	31,428	27,983
…		
Goodwill	10,513	9,710
Identified intangible assets, net	5,150	6,235
Other long-term assets	5,489	4,148
Total assets	$ 92,358	$ 84,351
Liabilities and stockholders' equity		
Current liabilities:		
Short-term debt	$ 281	$ 312
Accounts payable	2,969	3,023
…		
Total current liabilities	13,568	12,898
Long-term debt	13,165	13,136
…		
Stockholders' equity:		
…		
Retained earnings	35,477	32,138
Total stockholders' equity	58,256	51,203
Total liabilities and stockholders' equity	$ 92,358	$ 84,351

Source: https://www.sec.gov/Archives/edgar/data/50863/000005086314000020/a10kdocument12282013.htm.

Intel's consolidated balance sheet combines all of the company's operations from around the world.

Why the Income Statement Matters

Lecture 27

Of the four basic financial statements, the income statement is the one most widely followed and cited by the media and investment community. In fact, if you follow the business news during certain times of the year, the headlines are dominated by company earnings announcements that often focus on a few key metrics: revenue, gross margin, net profits, earnings per diluted share, and international sales. Each of these metrics is either explicitly disclosed on, or derived from, the company's income statement. In this lecture, we'll find out why both companies and financial markets consider these metrics to be of paramount importance.

Measuring Income

- The income statement details a company's revenue, expenses, and profits during a particular period of time, generally a quarter or a year. As we have discussed, GAAP requires the use of accrual accounting in generating income statements. As a result, the recognition of both revenues and expenses and, therefore, profits does not necessarily occur when cash is either received or paid out. Revenues are generally recognized as income when they have been earned through substantial completion of the activities involved in the earnings process.

- Put in more simple terms, revenues are considered earned when the company has essentially done what it promised a customer it would do and the customer has provided either payment or a promise of payment—an accounts receivable—to the company. The SEC has added its own guidance about when it is appropriate for companies to recognize revenue. According to the SEC, firms may recognize revenue when:
    - Evidence exists of an arrangement between buyer and seller

    - The product has been delivered or service rendered

- The sales price has been determined or is determinable

- The seller is reasonably sure it will collect the sales price.

- In principle, there are many complexities involved in revenue recognition. For example, insurance companies and companies involved in selling subscriptions or licenses may recognize revenue after cash is received. But in many other cases, revenue is recognized before cash is received, when a company provides a product or service to a customer in exchange for payment at some later time.

- Similarly, expenses can be recognized in different ways and at different times, depending on circumstances. Generally speaking, expenses are "matched" with their underlying revenues to provide as accurate a profit picture as possible. For example, cost of goods sold (COGS), shipping costs, and commissions should be allocated or matched to the revenues to which they relate.
  - Other expenses can be systematically and rationally allocated over time. For example, the cost of buildings and equipment is expensed or depreciated over the estimated period during which they will be in use. And the cost of patents is amortized over the period of time the patent lasts.

  - Finally, some expenses not tied to specific revenues are immediately recognized. These include most administrative costs; salaries; utilities; and selling, marketing, and advertising expenses. One other example in the United States is research and development costs, simply because the future benefit of such expenditures is highly uncertain, and thus, the more conservative treatment is to expense them immediately.

- The important point here is that revenue and expenses can be recognized at different times, depending on circumstances, and they may or may not be closely tied to the actual receipt or payment of cash. But our discussion so far reveals some important guidelines

for accountants: Revenues must be earned and realized; expenses must be matched with revenues; and when in doubt, be conservative in recognizing revenue or income.

Organization and Structure of Income Statements

- Broadly speaking, income statements detail two categories of income: income from continuing operations and irregular, nonrecurring, or extraordinary income items. Income from continuing operations includes all revenues and expenses, as well as all gains and losses arising from the ongoing operations of the firm. This category generally includes six components:
    - Revenues
    - COGS
    - Operating expenses
    - Other income
    - Other expenses
    - Income taxes.
- The starting point for any income statement is revenue, that is, the amount of sales generated during the financial reporting period, reduced by any sales returns or other discounts.
- Next, a typical income statement provides cost of sales or COGS. Three items make up COGS: direct labor, direct materials, and manufacturing overhead.
    - Direct labor is labor used in the process of manufacturing a company's products or, for a service provider, the cost of personnel directly involved in the delivery of services to customers. Direct materials are the costs of the raw materials included in the goods sold. Manufacturing overhead includes

certain indirect costs that are allocated to the products sold, such as rent, insurance, and utilities related to the manufacturing plant where a company's products are made.

  - Subtracting COGS from sales provides the first important and commonly cited subtotal in income statements: gross profit or gross margin. The gross profit percentage (gross profit divided by sales) is a widely cited measure of profitability and allows for simple comparisons between two years of operations and between different companies.

- Following gross profit, firms deduct other costs and expenses, generally known as operating expenses. These include almost all other costs and expenses not included in COGS, such as selling and marketing costs, delivery expenses, most depreciation, and expenditures on research and development. These expenses generally range from 15% to 20% of revenues, depending on the particular company or organization.

- The next subtotal on a typical income statement is operating income, which is the result of deducting the operating expenses from gross profit. This figure is often referred to as *earnings before interest and tax expense* (EBIT) and may be considered the most significant disclosure on the income statement. EBIT shows the amount of income or loss an organization actually generates from its normal and recurring activities.

- Following operating income, an income statement usually discloses other nonoperating income or expenses, such as interest income earned on investments or interest expense incurred on outstanding debt. Often, firms add the interest income and interest expense and report the net result as a single figure on the income statement.

- The next item on the income statement is income tax expense or the provision for income taxes.

- Note that this expense is not equal to the taxes paid during the year. Just as companies must use accrual accounting for all other revenues and expenses, income taxes are based not only on the current amounts payable but also on the anticipated future tax implications of current transactions.

- Note, too, that this item captures all of an organization's income taxes: federal, state, local, and international.

- Finally, it is possible that income taxes could be a positive figure, that is, an income tax benefit, as opposed to an expense.

- Once taxes are deducted from the income before taxes, the result is net income. Although this "bottom line" is certainly important, it might include one-time income or expenses that are not part of recurring operating results, which are what we really want to understand and evaluate.

- The final disclosure on the income statement is earnings per share, which is the net income divided by the weighted average number of shares of common stock outstanding during the period. Again, earnings per share is widely cited as a simple barometer of financial performance, usually compared to, or benchmarked against, Wall Street expectations.
  - Earnings per share is divided into two categories: basic and diluted. Basic earnings per share includes the shares of common stock that are currently issued and outstanding. Diluted earnings per share tries to capture the estimated impact of any stock options the company may have issued, as well as the impact of any securities the company may have that are potentially convertible into common stock at some point in the future.

  - By definition, diluted earnings per share must be less than or equal to basic earnings per share. Diluted earnings per share is the category most closely watched by investors and Wall Street analysts.

Key Questions

- There are four key questions we should ask about any income statement. First, is the company profitable or not?

- Second, what is the company's gross profit or loss, and how does the gross profit compare to both the operating income or loss and the bottom line?

- Third, how do the results compare to the prior period?

- Finally, do the reported results show any consistent and persistent trends? Because we usually evaluate historical financial results and accounting disclosures to predict the future, it is important to get a sense of how consistent past results have been.

EBITDA

- From the numbers on the income statement, we are able to calculate a significant and common measure known as *earnings before interest, taxes, depreciation, and amortization* (EBITDA).

- Why do we need to compute any metrics beyond those that already appear on the income statement? Remember that the income statement reflects not only normal and recurring operating expenses but also the impact of a company's financing choices.
    - For example, what if you were comparing two companies that had the same sales and operating expenses, but one had financed its business entirely with debt and the other, solely with investor equity?

    - The one that was funded with debt would show significant interest expenses and, thus, much lower income before taxes and lower net income. Should that company be worth less as a whole than the company funded entirely with stock?

    - Just as the value of your home does not depend on the amount of your mortgage, the answer here is generally no. This is an important concept that we will return to in a future lecture.

For now, we should simply appreciate the fact that a firm is not worth less as a whole because it has decided to fund its business differently.

- The other reason EBITDA is widely used is that it is supposed to be a proxy for the actual cash flows generated by the firm. As a result of accrual accounting, we cannot simply conclude that a company's reported profits tell us much about its actual cash flows. By adding back interest; income taxes; and certain non-cash expenses, such as depreciation and amortization, EBITDA provides us with a more reasonable approximation of a company's cash flows.

- The basic way to calculate EBITDA is as follows: EBITDA = Operating income or loss + Depreciation and amortization expense. Depreciation and amortization expenses are separately disclosed in the statement of cash flows, which we will discuss in the next lecture.

Suggested Reading

Collins, Johnson, Mittelstaedt, Revsine, and Soffer, *Financial Reporting and Analysis*, chapters 2–3.

Easton, McAnally, Sommers, and Zhang, *Financial Statement Analysis and Valuation*, chapters 3, 6–7.

Kieso, Weygandt, and Warfield, *Intermediate Accounting*, chapters 4, 18.

Questions to Consider

1. Using the 2013 annual report and Form 10-K for Time Warner Cable (http://ir.timewarnercable.com/files/doc_financials/Annual%20Reports/twc%20ar%202013.pdf), review the description of how the company recognizes revenues and costs in each of its businesses and business units (starting on page 70). Does the description make sense and seem consistent with the underlying nature of the particular business and/or transactions?

2. Review the 2013 income statement (consolidated statement of earnings) for Berkshire Hathaway (http://www.berkshirehathaway.com/2013ar/2013ar.pdf, page 29). How does the company identify its three business units? Which one reported the most pretax profits in 2013?

Income Statement: Apple Inc.

	Twelve Months Ended	
	September 28, 2013	September 29, 2012
Net sales	$ 107,910	$ 156,508
Cost of sales (1)	106,606	87,846
Gross margin	64,304	68,662
Operating expenses:		
Research and development (1)	4,475	3,381
Selling, general and administrative (1)	10,830	10,040
Total operating expenses	15,305	13,421
Operating income	48,999	55,241
Other income/(expense), net	1,156	522
Income before provision for income taxes	50,155	55,763
Provision for income taxes	13,118	14,030
Net income	$ 37,037	$ 41,733
Earnings per share:		
Basic	$ 40.03	$ 44.64
Diluted	$ 39.75	$ 44.15

Source: https://www.sec.gov/Archives/edgar/data/320193/000119312513416534/d590790d10k.htm.

An excerpt from Apple's income statement shows the typical structure of this type of disclosure.

How to Analyze a Cash Flow Statement

Lecture 28

The statement of cash flows allows us to reconcile accrual accounting and its impact on reported revenues and profits with actual cash flows. This statement is important in valuation because the value of any asset—stocks, bonds, or income-producing real estate—is the current value of the cash flows that asset is expected to generate in the future. In other words, the value of a company's stock today should be the value—in today's dollars—of the shareholder-level cash flows the company is expected to earn over time. Notice that we refer to valuation in the context of cash flows, not revenues or net income. Although revenues and profits are important, cash really is king in valuation.

Differences in Revenues, Profits, and Cash Flows

- As you recall, organizations that follow GAAP typically record revenues on the delivery of the product or service to customers. Although collectability of any amounts owed must be reasonably certain, customers may or may not ultimately make good on amounts they owe if they do not make payment at the time of the sale.

- For example, imagine that Cisco, the large telecommunications and networking equipment manufacturer, sells millions of dollars of equipment to a start-up. As long as Cisco has delivered the equipment to the customer and the customer promises to pay for it, Cisco can record the revenues and profits related to that sale, although the actual cash from the sale will come later. But what if the start-up goes out of business before it has paid the full amount it owes to Cisco?

- Most companies require that customers pay their receivables within 30 to 90 days following a sale. Procter & Gamble, the multinational consumer products company, collects receivables from its customers—Walmart, Costco, Target, and so on—

on average, in about a month. On the other extreme, finance companies, which make business or home loans, make take years to collect their receivables.

- In simple economic terms, companies generally report and record revenues and profits before they collect the cash. If the time lag is only a few months, that might not be a problem. But what if it takes longer or the customers ultimately don't pay? You can imagine how such companies as Cisco performed during the dot-com bubble in the late 1990s or how homebuilders and banks performed in the mid-2000s. Initially, they reported fantastic revenues, profits, and earnings per share, but ultimately, they took large losses when customers did not pay as expected.

- In 2010, Green Mountain Coffee reported tremendous growth in revenues and profits but far lower cash flows. It's easy to imagine how this difference occurred: The company sells its coffee makers to department stores and other retailers, providing liberal credit terms that allow these customers to pay off the receivables over an extended period of time. As long as Green Mountain ultimately expects to get paid, it can record the revenue and the profits immediately. But there would then be potentially large discrepancies between these profits and the actual operating cash flows of the company, at least in the short run.

- In contrast, in 2011, Apple reported cash flows that were higher than net profits. This difference can be attributed to two considerations: First, Apple typically receives cash immediately when it sells its products. Second, because Apple has so many stores, the company reports a fair amount of depreciation expense, which reduces reported profits but has no impact on cash flows. Thus, for companies with high non-cash expenses, actual operating cash flows can be higher than reported profits.

- For these reasons, in evaluating financial statements, we want to compare reported accrual-based profits and cash flows, looking for a close relationship between the two.

Operating Cash Flow

- Overall, the statement of cash flows lays out both the sources and the uses of cash during a particular period of time, generally a quarter or year, the same period covered by the income statement. The statement of cash flows is divided into three sections: operating, investing, and financing. The total of those three cash flows yields the total change in cash for the period.

- The operating section of the cash flow statement discloses the actual cash either generated or used by the company in the normal, recurring, and routine course of business. Here, firms start with the net income reported on their income statements; by making certain additions and deductions to reconcile the reported income to cash flows, they then derive the actual operating cash flows.

- As a starting point, firms add back any non-cash expenses they may have recorded in the income statements, such as depreciation and amortization expense or compensation expense from stock options, all of which require no outlay of cash. Then, to the extent they reported various revenues and/or expenses either greater or less than the actual cash received or spent, they add or subtract those differences.

- For example, if a firm sold more product on credit than it collected in cash, we would see, of course, a net increase in the company's accounts receivable on the balance sheet. On the statement of cash flows, this net increase in receivables would be subtracted from net income to compute actual operating cash flows.

- The operating section of the statement of cash flows may be the most important section of a quarterly or annual report because it allows us to see whether a firm is generating or bleeding cash. It also shows us how closely cash flows track net income. As we would expect, most mature companies generate positive cash flows from operations, while start-up companies, certain technology companies, and seasonal businesses might not.

- As mentioned in the last lecture, EBITDA is a metric that is widely used in finance and valuation. The most common method for calculating EBITDA is to start with the operating earnings or loss from the income statement, then add back depreciation and amortization expenses, which are disclosed in the statement of cash flows.

Investing Cash Flow

- The investing section of the statement of cash flows lays out the cash flows from various nonrecurring, nonoperating activities of the firm. These may include investments in property, plant, or equipment; mergers and acquisitions; or investments in stocks and bonds. Investing cash flows are usually negative, because all organizations, even those that are losing money, tend to make at least some investments, even if only to replace outdated computers and equipment.

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All companies need to make some investment in capital expenditures, such as new property or equipment, to replace obsolete machinery and to grow.

- The most important figure in this section is capital expenditures—additions to property, plant, and equipment. All firms need to reinvest at least some amount of cash into the business to maintain their current level of operations as machinery wears out and computers and other equipment become obsolete. Then, companies need to invest if they intend to grow.

- Thus, the difference between operating cash flows—the cash generated by or used in normal business operations—and amounts expended on capital expenditures is often referred to as *free cash flow*. That's the leftover cash that firms can spend on acquisitions, dividends, stock repurchases, reductions in debt, stocks and bonds, and so on.

- In fact, free cash flows are arguably the most important link between accounting and finance, certainly when it comes to the valuation of stocks.
    - When you buy shares of stock in a company, you are basically purchasing a share of the free cash flows that the company is expected to generate in the future and that you, as a shareholder, own a right to or an interest in.

    - As mentioned, the historical results of the company are important, but only inasmuch as they provide information to help predict or anticipate the future. Therefore, in accounting and finance terms, we say that the price of any stock should be the present value of a company's expected free cash flows to be earned by shareholders over time.

    - Free cash flows represent the cash that a company or organization is able to generate from its core operations, less any expenditures it must make to maintain its asset base. Free cash flow is important because it allows a company to pursue opportunities that enhance and grow shareholder value.

- One way to calculate free cash flow is with the "eyeball method"; here, you simply start with the cash flows from operations and subtract the capital expenditures. The only shortcoming of this metric is that it includes interest expense, which is usually ignored in valuation. In a later lecture, we will look at a more precise measure of free cash flows that is free from the impacts of leverage and interest expense.

Financing Cash Flow

- Financing activities include any cash transactions involving an organization's debt or borrowings, as well as its equity or stock. These transactions may include borrowing, that is, issuing bonds or taking out a loan from a bank; paying back such debt; issuing or repurchasing stock; or paying dividends. Not surprisingly, these activities are directly tied to operating and free cash flows. Companies with significant free cash flows can generally pay down their debt and pay dividends.

- More than 70% of U.S. companies generate positive cash flows from operations, and more than 80% generate negative cash flows from investing activities. However, we cannot generalize about cash flows from financing activities because even successful companies with significant free cash flows may issue stock or debt to fund growth or acquisitions or to take advantage of opportunities in the market.

Reviewing the Statement of Cash Flows

- In reviewing a company's statement of cash flows, first, we want to review the total amount of operating cash flows generated for the year to look for noticeable trends over recent years. Clearly, we would like to see positive operating cash flows that are growing from year to year.

- Second, we want to compare the reported operating cash flows to net income. If there are large differences, we should investigate what might be driving them. Is the company not collecting its

receivables? Does the company have significant non-cash income? Because the operating section of the statement of cash flows requires firms to reconcile net income to operating cash flows, we can generally see what is driving the difference.

- Finally, we want to see what the company actually did with the money it made. Or if the operating cash flows are negative, we want to know how the company dealt with that shortfall. Did the firm sell assets, issue stock, borrow money, or use cash reserves?

Suggested Reading

Collins, Johnson, Mittelstaedt, Revsine, and Soffer, *Financial Reporting and Analysis*, chapter 4.

Easton, McAnally, Sommers, and Zhang, *Financial Statement Analysis and Valuation*, chapter 2.

Kieso, Weygandt, and Warfield, *Intermediate Accounting*, chapters 5, 23.

Questions to Consider

1. If an organization’s cash flow from operations is negative, what are the potential sources of cash for the organization to remain in business?

2. Which industries would you expect to have especially seasonal cash flows during the year? Examine several cash flow statements for a company or company in that industry within a given year. Are the cash flow statements consistent with what you anticipated seeing?

Common Size, Trend, and Ratio Analysis

Lecture 29

In this lecture, we will get an overview of three financial analysis tools: common size analysis, trend analysis, and ratio analysis. Each of these tools can be used to analyze a company's historical performance, to make comparisons between firms, and to predict future results. And all of them rely on the financial statements we've already discussed: the income statement, balance sheet, and statement of cash flows. To make our discussion of the tools concrete, we will use Procter & Gamble (P&G) as our starting point. P&G is the world's largest consumer products company, with nearly $84 billion in sales and 25 different billion-dollar brands, including such household names as Tide, Crest, Charmin, and Bounty.

Common Size Analysis

- A quick review of P&G's 2013 income statement shows revenues of $84.2 billion, operating income of $14.5 billion, and net income of $11.3 billion. Obviously, P&G is a large and profitable firm, but how should we evaluate its financial performance? Is the company growing? Is it doing better or worse than its competitors? We need some analytical tools to help answer these questions.

- The first tool we need is common size analysis. This analysis involves converting all the absolute figures on the company's financial statements to percentages. By doing this conversion, we will be better able to compare P&G's performance over time and to its competition.

- In a common size income statement, we simply compare all line items to sales or revenues, setting sales or revenues equal to 100%, as shown on the following page.

Line Item	Reported in 2013	Converted to Percentage
Revenues	$ 84.2 B	100.0%
COGS	$ 42.4 B	50.4%*
Operating income (operating margin)	$ 14.5 B	17.2%
Net income (net margin)	$ 11.3 B	13.4%

*Subtracting the COGS percentage from the revenue percentage yields a gross profit percentage (or gross margin) of 49.6%.

- The math is not that complicated, but the results are powerful. In a few quick steps, we can compute P&G's 2013 gross margin, operating margin, and net margin. We can then compare those figures to prior years and to competitors (as shown below). To the extent that the results are greater or less than expectations or budgets, prior year results, or competitors' figures, management can perform further analyses and, perhaps, make strategic changes.

Line Item	P&G 2013	P&G 2012	Colgate-Palmolive 2013
Gross margin	49.6%	49.3%	58.6%
Operating margin	17.2%	15.9%	20.4%
Net margin	13.4%	12.9%	12.9%

- Common size analysis also tells us about a firm's *operating leverage*. This term refers to an entity's cost structure and whether it mostly consists of *fixed costs*—those that don't change with increases in sales volume, such as rent—or *variable costs*—those that change proportionately as sales volume increases, such as sales commissions.

Trend Analysis

- We can gauge operating leverage and performance over time through trend analysis. Here, we first choose a particular base year and set every figure in that year's financial statements equal to 100%. Then, we look at subsequent years, comparing each line in the financial statements to the base year (again, converting to percentages) to see how the financial statement lines are trending.

- In 2011, P&G reported revenues of $81.1 billion. If we set this figure equal to 100%, we can then compare the 2012 and 2013 revenues to the 2011 figure and gauge the resulting trends. For example, P&G reported 2012 and 2013 revenues of $83.7 and $84.2 billion, respectively. If we divide those revenues by the base revenue of $81.1 billion, we see that revenues grew by 3.2% from 2011 to 2012, but the recent trend is much lower; 2013 revenues grew only 3.8% compared to revenues in 2011.

- More troubling, we find that 2012 operating income was less than 86% of 2011 levels. Although 2013 operating income was 93.5% of 2011 levels, the trend was still down over the past couple of years. And net income shows similar trends. Operating leverage was, therefore, negative because increases in revenues did not translate to higher profits.

- You would probably not be surprised to learn that P&G made substantial changes in 2013, including replacing the company's CEO. Sales revenues increased modestly each year, but trend analysis revealed that the company's profitability was waning because costs were growing faster than sales revenue.

Applying Analyses to Other Financial Statements

- The approach to common size and trend analysis for both the balance sheet and the statement of cash flows is similar to that used with the income statement. Trend analysis is straightforward: We select the base year, which should be the same year as that set for the income statement trend analysis, and compare that year to later years on the balance sheet or statement of cash flows.

- For common size analysis, we need to choose the denominator, or the particular line on the balance sheet or cash flow statement that will be set equal to 100%.
    - For the balance sheet common size analysis, we use total assets as the denominator. Thus, at the end of 2013, P&G reported total assets of $139.3 billion. We then compare every other balance sheet line item to this figure, putting the results in

percentage terms. For example, total long-term debt for P&G in 2013 was $19.1 billion. We divide that number by $139.3 billion and see that long-term debt was 13.7% of total assets.

- To perform a common size analysis for the statement of cash flows, the typical approach is to compare each of the line items to total sales revenue, which is drawn from the income statement. We can also gain interesting insights by comparing each of the line items to cash flows from operations. For example, in 2011, P&G's net income from the statement of cash flows was $11.9 billion, nearly 90% of the operating cash flow of $13.3 billion. But in 2013, that same figure declined to less than 77%. Why?

- It appears that P&G sold some businesses, reporting gains on the income statement and improving the bottom line but not improving operating cash flows. However, P&G's 2013 operating cash flows were $14.9 billion, compared to $13.3 billion in 2011, an increase of about 12%.

Liquidity and Efficiency Ratios

- Like common size and trend analysis, ratio analysis can be used to analyze many aspects of a company's financial performance. There are five categories of ratios to consider:
    - *Liquidity ratios*.

    - *Profitability ratios*.

    - *Efficiency* or *activity ratios* (*turnover ratios*), which measure how efficient an organization is in managing its working capital.

    - *Leverage* or *solvency ratios*, measuring the overall riskiness of an organization and its ability to service its longer-term obligations.

    - *Market ratios*, which serve as a link between accounting disclosures and valuation.

- The most common ratio to measure organizational liquidity is to divide the total current assets by the current liabilities at any balance sheet date. This yields the *current ratio*. Generally, we want to see current ratios of at least 1.0, indicating that current assets at least cover current liabilities. Even better, we'd like to see current ratios of 2.0, indicating that current assets are at least twice current liabilities.

- One efficiency ratio is the *accounts receivable turnover ratio*, which measures how quickly, on average, a company is able to collect its receivables from customers.
    - The formula for this ratio is sales revenue divided by average accounts receivable for a defined period. To find the average accounts receivable, add the balance of receivables (from the balance sheet) at the start of the period to the balance at the end of the period and divide that sum by 2.

    - Dividing revenues by that average balance reveals how many times, on average, the company collected its receivables during the period. We then divide that result into 365 days to see how long a typical receivable is outstanding before it is collected.

- The *inventory turnover ratio* measures how quickly a company turns over or sells its inventory. The formula is similar to that for the accounts receivable turnover ratio, except that instead of sales revenue in the numerator, we use COGS, and divide by the average inventory balance during the period.

- The *accounts payable turnover ratio* uses the same approach, dividing COGS by the average accounts payable balance.

Profitability Ratios

- We've already encountered some profitability ratios—specifically, the gross, operating, and net margin percentages derived from common size analysis. The other set of profitability ratios are *return on investment* (ROI) metrics, including *return on assets* (ROA) and *return on equity* (ROE).

- ROA is calculated by dividing a company's earnings before interest expense during a certain period by the average total assets the company has outstanding during that same period. To compute the numerator—earnings before interest—we start with the reported net income, add back the interest expense incurred during the period (adding back any taxes saved from the interest expense), then divide that result by the average assets, computed as the beginning total assets and the ending assets, divided by 2.
  - ROA is essentially a combination of two elements: profit margins and asset efficiency.

  - If an organization is both profitable and manages its assets efficiently, ROA is maximized.

- ROE is calculated by dividing net income by average shareholders' equity. ROE is a combination of three elements: profit margins, asset efficiency, and leverage—the amount of long-term debt an organization has.
  - It makes sense that a company can improve its ROE by being more profitable and efficient, but it may not be intuitive that it can improve ROE by increasing its debt, all else equal.

  - Essentially, the cost of debt is cheaper than the cost of equity. That is, the return that lenders get when we borrow is less than the return we expect from capital.

Leverage and Market Ratios

- Leverage or solvency ratios are additional measures to determine the risk associated with a firm and whether it will be able to meet its longer-term obligations. Leverage ratios include the ratio of a firm's long-term debt to total assets, shareholders' equity to total assets, and operating income to interest expense (*interest coverage ratio*).

- Market ratios allow us to bridge accounting disclosures and market valuation. A common example is the *price-earnings ratio*, which is calculated by dividing a company's stock price by its earnings per share. Other examples include the ratio of a company's total stock market value to total revenues, known as the *price-to-sales ratio*. We'll return to these ratios in a later lecture.

Suggested Reading

Alvarez and Fridson, *Financial Statement Analysis*, chapter 13.

Collins, Johnson, Mittelstaedt, Revsine, and Soffer, *Financial Reporting and Analysis*, chapter 5.

Questions to Consider

1. In the last several years, interest rates have declined significantly, causing firms to borrow significant sums in the form of bond issuances and bank loans. Many times, firms use these funds to repurchase shares of stock. How would these transactions increase a firm's leverage and return on equity ratios, and why?

2. Warehouse clubs, such as Costco, Sam's Club, and BJ's Wholesale Club, and even certain large retailers, such as Walmart, have current ratios of less than 1.0. Explain how this can occur.

Cost-Volume-Profit Analysis

Lecture 30

Breakeven analysis is a managerial accounting tool with widespread application. Whenever a firm is considering introducing a product or offering a new service, managers must ask: How many units of the product do we need to sell or how many client hours do we need to bill to break even? Breakeven analysis is more formally known as *cost-volume-profit analysis* because the goal of any business is not just to break even, of course, but to generate enough profit on the capital investment required to produce, market, and distribute the new brand or offer the new service, given the costs involved. Therefore, once we introduce the basic breakeven model, we will complicate it so that it can be used to provide profit forecasts, assistance in budgeting, and answers to many "what-if" questions.

Types of Costs

- The first step in cost-volume-profit analysis is to restate the traditional financial accounting profit formula. As you recall, this formula starts with sales, then deducts COGS, various operating expenses, and income taxes in order to compute net income or loss.
  - In cost-volume-profit analysis, we also start with revenues, but instead of lumping all expenses together as selling, general, or administrative, we break down all expenses into two categories: fixed or variable. Remember that traditional financial accounting is concerned only with whether an expense is operating—related to core and recurring operations—or not. In managerial accounting, however, we want to know how a particular cost or expense behaves over changing levels of activity.

  - Fixed costs, such as rent or insurance, remain the same regardless of how well or poorly a firm is doing. In contrast, variable costs, such as sales commissions, vary directly with the volume of business the firm generates.

- Mixed or semi-variable costs are a combination of these two. Most utilities, for example, have a fixed component, a minimum amount we have to pay each month, and an amount on top of the minimum based on the actual electricity, gas, or water used. In such cases, the fixed portion of the costs can be separated from the variable portion.

- Finally, it's important to note that all costs vary in the long run. For example, if your business is doing well and expanding rapidly, you may need to open a second location in order to increase capacity, which would add a layer of additional fixed costs. Thus, we can think of costs as being fixed over some level of volume or activity, then jumping up to another level of fixed costs, and so on.

- The important point here is that if you want to make key business decisions, you need to understand and distinguish among the types of costs your business incurs. Traditional financial accounting categories, such as selling, general, and administrative expenses or research and development costs, are simply inadequate for this task.

Managerial Accounting Profit Formula

- To restate the basic profit formula in managerial terms, we start with revenues, then subtract total variable costs, followed by total fixed costs to derive profit or loss:

  Revenues − Total variable costs − Total fixed costs = Profit or loss

- The next step is to break this formula down into smaller components, so that we can compute the breakeven point and run numerous what-if scenarios.
  - Revenues are made up of two components: the average selling price for the products or services multiplied by the volume of products or services sold—basically, price multiplied by quantity.

- ○ Similarly, the total variable costs also have two components: the quantity of product or services sold multiplied by the average variable costs incurred in each transaction.

- ○ Fixed costs are a constant.

- We now have a more detailed equation: Revenue, broken down by sales volume and average sales prices, minus total variable costs, also broken down by average variable costs and volume, minus the fixed costs constant. Note that one of the variables in both revenues and total variable costs is sales volume—the number of units sold.

- Because our initial objective is to solve for the breakeven point, we will set this entire equation equal to zero. Therefore, the breakeven formula is:

  (Average sales price per unit × Number of units sold) − (Average variable costs per unit × Number of units sold) − Fixed costs = 0

- We then solve for the breakeven quantity, as follows:

  Breakeven quantity = Total fixed costs during the period/ (Average sales price per unit − Average variable cost per unit)

Unit Contribution Margin

- The denominator in the breakeven formula—average sales price minus average variable cost—is known as the *unit contribution margin*. Contribution margin helps business owners and managers not only with budgeting and forecasting but also in making sales, marketing, and pricing decisions, providing data on the incremental contributions that every sale makes.
  - ○ Imagine that you own a Subway sandwich shop and you're considering opening a new location. You estimate that the total fixed overhead each month, consisting of rent, insurance, utilities, and so forth, is $25,000. You further assume that the

average customer spends \$8.00 per visit and that the average variable costs for that meal are \$3.00, consisting principally of food costs and royalties.

  - If you plug these assumptions into the breakeven formula, you get \$25,000 divided by a unit contribution margin of \$5.00 (\$8.00 − \$3.00). Doing the math, you find that the breakeven number of customers is 5,000. You could then analyze whether you expect enough traffic to generate that much business each month.

  - Note that in this example, each customer visit and meal sold contributes \$5.00, on average, to cover the fixed costs of the business. The starting point and initial objective of the business is to sell enough sandwiches—to generate enough customer visits—to break even. After that, the objective is to generate a return above breakeven, enough to compensate for the risk and capital invested in the business.

- What other decision-making implications does the contribution margin concept have? Imagine that you own a hotel, and one night, you have some available rooms. A traveler walks in, asks the price of a room, and then asks if you can reduce the price. Should you negotiate?
  - As the proprietor, you know the variable costs of providing the room for the night—principally, housekeeping, linen cleaning, utilities, and toiletries. In theory, if you charge anything above those variable costs, then the difference contributes to cover the fixed costs of the hotel, which tend to be very high. Another way of thinking about this question is that the opportunity cost of having a hotel room sit empty is significant.

  - Therefore, the concept of contribution margin has special significance to those businesses with high operating leverages, such as airlines, hotels, and universities. Think about the contribution margin of each ticket sold on an airplane. The

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Recent bankruptcies in the airline industry reflect the economic realities of high fixed-cost businesses during tough economic times.

incremental or variable costs associated with this additional traveler are relatively minor compared to the price of a ticket, but the consequences of serving an extra traveler are meaningful. The revenue generated contributes substantially to the high fixed costs and falls right to the bottom line.

- Unfortunately, the flipside is also true. The opportunity cost of an unsold seat is very high. The profits of businesses that have high fixed costs tend to be volatile and cyclical, moving up or down sharply along with changes in underlying economic conditions.

- The contribution margin concept can also help a business that produces different products decide which one to promote or emphasize if production capacity is constrained. The answer in this case would be the product with the highest contribution margin because for any level of capacity, maximizing contribution margin maximizes profits. In other words, for any level of fixed costs, if you maximize the difference between revenues and variable costs, you maximize profit.

Solving for Target Profit

- Obviously, the goal of any business is not to break even but to generate a profit or surplus. How can we use the basic breakeven formula to solve for a target level of profit? Let's say that a company sets a particular target profit, perhaps because of demands from shareholders, owners, or Wall Street. Then, the breakeven question is reoriented. How many units does the company need to sell or how many hours does it need to bill to achieve the target profit?

- To answer that question, we need to tweak the breakeven formula. We need to add the after-tax target amount of profit we wish to generate, after converting it to a pretax figure, and instead of computing for the breakeven point, we calculate the target level of volume needed to achieve the desired results.

- For example, if we assume that the target profit is $490,000 after taxes and the total tax rate is expected to be 30%, we first need to convert the after-tax profit target to a pretax figure. Then, we simply add this result to the fixed costs in the breakeven formula.
    - For example, if the promoter of a Rolling Stones concert wants to generate an after-tax profit of $490,000 and has a tax rate of 30%, the concert will need to generate $700,000 of pretax profits. To derive this result, we simply divide the after-tax profit target of $490,000 by 1 − 30% (the tax rate), or 0.7: $490,000/0.7 = $700,000.

- Once we have the pretax profit computed, we simply add it to the fixed costs and recompute the breakeven point, although now it is not a breakeven point but a target volume.

- Recall the breakeven formula:

  Breakeven quantity = Total fixed costs during the period/ (Average sales price per unit − Average variable cost per unit)

  The original fixed costs of the concert were $2 million; to that, we add $700,000 to get a numerator of $2,700,000. If we assume an average ticket price of $350 and subtract the average variable costs per ticket of $20, we get a denominator, or unit contribution margin, of $330. Next, we divide $2,700,000 by $330, which tells us that the number of tickets we need to sell to generate the target profit is 8,182.

• Up to this point, we have computed the overall volume needed to either break even or generate a target pretax profit, but we have not considered how this translates into sales of individual products or services for firms that sell more than one thing.
  - For example, in our Rolling Stones example, we computed the target ticket sales at about 8,200 fans, but we know that concert venues have different types of seats for which they charge different prices.

  - Thus, it's important to keep in mind that when we are computing the breakeven point or the target volume, we are taking a weighted-average contribution margin.

Suggested Reading

Cafferky and Wentworth, *Breakeven Analysis*.

Eldenburg and Wolcott, *Cost Management*, chapter 3.

Questions to Consider

1. Consider two industries with high operating leverage, characterized by especially high fixed costs. How do you expect these industries to perform during economic recessions? Why?

2. In the last few years, airlines have begun to charge coach passengers for just about everything, including checked bags, food, and headphones. How does this policy affect the airlines' contribution margin and breakeven points, respectively?

Understanding the Time Value of Money

Lecture 31

Over the past six lectures, we've explored several essential topics in the field of accounting. With that foundation laid, we'll now move into the finance lectures, starting with perhaps the most important concept in finance: the time value of money. This concept has broad applications across an array of financial decisions, such as what investments we should consider; how much a stock, bond, or piece of real estate might be worth; when we should retire; or whether a municipality should offer tax incentives to businesses to relocate. In fact, not a single financial or investment decision does not involve the basic ideas behind the time value of money principles we will discuss in this lecture.

A Dollar Today versus a Dollar Tomorrow

- Most of us have an intuitive sense that a dollar in our pockets today is worth more than that same dollar tomorrow. The primary reason this is true is that we are able to invest money we have today and earn some return on it. And we all prefer current consumption over future consumption, all else equal; thus, we must be compensated in some way to give up current consumption for something in the future.

- The other way to think about this basic concept is related to inflation; price increases mean that we can purchase less in the future with the same money we have today. Again, most of us can intuitively understand that in the event of higher inflation, the value of money in our pockets decreases.

- We also have to consider risk: Future cash flows involve the risk that for some reason or another, we might not get the cash we expect.

- For all these reasons, time most definitely is money, but the question is: How much? How much more is your money worth today versus tomorrow or next year or 10 years from now? To answer that question, we need to introduce two related terms: *discounting* and

discount rate. Discounting is the process by which future cash flows are adjusted to some equivalent amount today. The discount rate is the interest rate used to capture inflation, risk, and our preference for current consumption over future consumption.

Compounding

- Let's start with a relatively simple example to highlight some mechanics of the time value of money. Assume you invest $100 today and earn 4% each year on that investment after taxes. By the end of the first year, you'll have $104. At the end of the second year, you'll have $108.16, and at the end of the third year, you'll have $112. 49.

- This example represents the relatively simply but powerful concept of *compounding*, the idea that you earn returns not just on your original investment but on any return that investment has previously generated. It may not seem like much, but over a longer-term investment horizon, the additional money can add up.

- Without question, compounding is a critical component of the time value of money, but it also has a flipside. Let's say you plan to keep $100 under your mattress. Let's also assume that inflation is 4% a year. In this scenario, you lose significant purchasing power after two years because your $100 cannot buy the same amount of groceries or gas that it could previously. In addition, your loss of purchasing power compounds over time. Each year you can afford less.

- At this point, let's introduce two more important terms in finance: *present value* and *future value*. Present value represents the value of a future cash flow we expect to receive in today's dollars. That is, if you expect to receive $100 in three years, how much is that worth today? Future value is essentially the opposite; it represents the value in the future of some amount invested today.

- In our previous example, we would say that the future value of $100 invested for two years at 4% compounded annually is $108.16. Conversely, we would say that the present value of $108.16 received in two years at a discount rate of 4% is $100.

Single Cash Flows

- There are five types of cash flows we need to discuss to link the time value of money concept to real-world finance and investment examples: single cash flows or lump sums, annuities, growing annuities, perpetuities, and growing perpetuities. We'll start with single cash flows.

- A single cash flow represents a specific and fixed amount of cash that will be received or paid in the future, perhaps a lump sum payment from a retirement plan or the cash expected from the future sale of a home. We can discount those expected future cash flows to the present using a discount rate that reflects the uncertainty of the cash flow.

- The present value of a single future cash flow is calculated as follows:

  $$\frac{CF}{(1+i)^t}.$$

  The lump sum of cash at some specific time in the future is denoted by *CF*, the discount rate is denoted by *i*, and the number of years in the future when the lump sum is expected to be received is denoted by *t*.

- Suppose you expect to receive \$500,000 from the sale of your house in 15 years, and assume that the discount rate is 7%. If we plug the numbers into the formula, we get:

  $$\frac{\$500{,}000}{(1+.07)^{15}} = \$181{,}223$$

  That is, receiving \$500,000 in 15 years at a discount rate of 7% is the same thing as receiving \$181,223 today. In other words, \$181,223 is the present value of that future cash flow.

- Note that the further out t is—the longer you have to wait to receive the cash—the less valuable the payment is in present-value terms. Also notice that as the discount rate increases, the present value of future cash flows decreases. That makes sense because if inflation is higher, the value of your money decreases.
    - But the discount rate must also capture the riskiness of future cash flows. In other words, higher-risk investments with more uncertain cash flows must be discounted at a higher rate. That means we should be willing to pay less for those investments today.

    - For example, a \$500,000 payment to be received in 15 years is about \$321,000 at a 3% discount rate and less than \$62,000 at a 15% discount rate. As the discount rate increases and everything else stays the same, the present value of the money drops considerably.

Annuities

- An annuity is a constant cash flow that occurs at regular intervals during a fixed period of time. For example, payouts from retirement plans or insurance policies are routinely structured as annuities.

- The present value of an annuity can be calculated by taking each individual future cash flow, discounting it back to the present through the present-value formula, then adding up all the individual present values. Another method is to multiply the amount of the annuity payment or receipt by a formula that captures the sum of all the individual present values. This *annuity factor* formula is shown below:

Present value of annuity =

$$\text{Amount of annuity} \times \frac{\left[1-\left(1/\left(1+i\right)\right)^{t}\right]}{i}$$

- This formula can be used in several real-world applications. For example, let's compute the monthly mortgage payment on a 30-year loan of $300,000, with an interest rate of 4.5%.
    - The present value of the mortgage is the amount you plan to borrow: $300,000. The monthly interest rate is 4.5% divided by 12, or 0.375%, and the total number of payments is 360.
    - If we substitute the variables into the annuity equation, we find that the monthly payment will be a little more than $1,520.
- We can also modify the annuity present-value formula fairly easily to compute the future value of an annuity. This formula is useful for estimating how much money you'll have at retirement if you save consistently over time. The formula is:

$$\text{Future value of annuity} = \text{Amount of annuity} \times \frac{\left[(1+i)^t - 1\right]}{i}$$

Growing Annuities

- A growing annuity is an investment that provides growing cash flows or returns over time, rather than returns that remain constant.
- Imagine a hospital considering an investment in a new and expensive surgical robot. This equipment requires an upfront investment of some $2 to $3 million; thus, any hospital purchasing one would expect its investment to generate significant and presumably increasing cash flows over the robot's expected useful life.
- Let's assume that one surgical robot could perform 400 procedures each year, generating $500,000 in expected profits in its first year of use. Let's further assume that this profit is expected to grow by 5% each year because the prices charged for various surgical procedures inevitably increase and more doctors use them. Finally, assume that the robot will last five years before it must be replaced.

- Under these assumptions, what is the present value of this growing annuity? The *growing annuity factor* formula is shown below:

  Present value of a growing annuity =

  $$[\text{Annuity} \times (1+g)] \times \frac{\left[1-\dfrac{(1+g)^t}{(1+i)^t}\right]}{(i-g)}$$

  The formula looks fairly complex, but it has just four variables: (1) the amount of the initial annuity, here, \$500,000; (2) the expected growth rate in the annuity, g, here, 5%; (3) the amount of time the annuity will last, t, here, 5 years; and (4) the discount rate, i, assumed here to be 10%. If we plug in the numbers, we get:

  Present value of a growing annuity =

  $$[\$500{,}000 \times (1+0.05)] \times \frac{\left[1-\dfrac{(1+.05)^5}{(1+.1)^5}\right]}{(0.1-0.05)}$$

- Given our assumptions, the present value of this growing annuity is \$2,179,060. Note that as long as the robot costs less than the present value of the expected future cash flows, the hospital should make the investment.

Perpetuities and Growing Perpetuities

- A perpetuity is an annuity of a constant cash flow—inflow or outflow—that lasts forever. One example is a type of bond first issued by the British government in the 18th century known as a *consol bond*. By definition, these bonds never mature; since 1923, they have yielded only 2.5%, but they will pay interest to their owners forever.

- The present value of a perpetuity is a relatively simple formula:

$$\text{Present value of perpetuity} = \frac{\text{Amount of constant annuity}}{i}$$

- For a consol bond with a face value of \$1,000, paying 2.5% interest once a year, and a discount rate of 6%, the present value would be \$416.67.

- A growing perpetuity is a cash flow that is expected to grow at a constant rate forever. It is often used to help value stocks for certain companies, such as IBM or Disney, that are likely to be in business indefinitely and should grow at a fairly constant rate over time.
  - The present value of a growing perpetuity can be calculated by dividing the amount of the perpetuity expected next year, denoted as CF_1, by the difference between the discount rate and the growth rate:

$$\frac{CF_1}{(i-g)}.$$

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A piece of real estate that is likely to stay fully leased in perpetuity, such as an office building in Manhattan, is an example of a growing perpetuity.

- Imagine that an apartment building near the UCLA campus has current cash flows (the difference between all rents and all expenses) equal to $100,000. These cash flows are expected to grow 5% each year in perpetuity, and the discount rate for such an asset is 8%.

- We start by computing next year's expected cash flows, which in this case would be $105,000: the $100,000 currently being earned plus the 5% growth rate. We then divide by the difference between the discount rate of 8% and the 5% growth rate: $105,000/3%. The result is $3.5 million, which is the present value of this stable, well-located apartment asset.

Suggested Reading

Berk and DeMarzo, *Corporate Finance*, chapter 4.

Brealey, Myers, and Allen, *Principles of Corporate Finance*, chapter 2.

Kieso, Weygandt, and Warfield, *Intermediate Accounting*, chapter 6.

Questions to Consider

1. As interest rates decline, stock and bond prices generally increase. Why?

2. Someone leaves you an odd inheritance, promising to pay your and your heirs $100 each year until the end of time. How much would such a perpetuity be worth in today's dollars?

The Trade-Off between Risk and Return

Lecture 32

Any asset's expected return is based on historical returns, which provide some basis for predicting likely future results, at least over extended periods of time. But it's also true that actual results may vary, certainly over shorter investment periods. In addition, although we may expect to earn higher returns with higher risk, we cannot and should not expect to be compensated with additional returns for that portion of risk that is stock-specific and can be diversified away. In this lecture, we'll look at the capital asset pricing model (CAPM), which provides a powerful means of formally unifying an asset's expected return and risk, defining risk primarily in terms of how an asset fluctuates in comparison to the overall markets.

Historical Asset Performance Data

- When we pursue investment opportunities, whether they are stocks, bonds, real estate, or alternative investments, we should have some idea of the returns we expect to receive. Generally, these expectations are based on history—how these assets have performed and the returns they have generated in the past.

- For some assets, we have good historical performance data. For others, the historical data are less robust. For example, we have extensive data on returns from the equity and bond markets over an extended period of time. (See below.)

Equity and Bond Market Returns, 1926–2013

Asset Class	Average Annual Return	Standard Deviation of Returns
Large-cap domestic stocks	12.1%	20.2%
Small-cap domestic stocks	16.9%	32.3%
Long-term corporate bonds	6.3%	8.4%
Long-term U.S. government bonds	5.9%	9.8%
U.S. treasury bills	3.5%	3.1%
Inflation	3.0%	4.1%

- Over time, stocks significantly outperform bonds, and both significantly outperform inflation. However, within each category of investment, the more risk that's involved, the greater the return. For example, small stocks have earned, on average, 16.9% each year since 1926. Compare this to the 12.1% return that larger companies have earned.

- The reason we consider long-term rates of return is that the short term can be volatile. If we look at results over longer time periods, short-term blips should be evened out.

- Volatility in asset prices is measured statistically by the standard deviation of historical returns—how much a particular year's return varies in relation to long-term averages. Again, if we look at the historical data for stocks and bonds, we see that small-cap stocks have earned an average of 16.9% per year since 1926. However, their standard deviation is over 32%, substantially higher than any other category of investment.

- The important point to remember here is that asset and portfolio returns are based on expectations, and those expectations, in turn, should be based on long-term historical observations.

Diversifiable Risk

- Although higher expected returns are positively correlated with higher risk, the fact that you assume greater risk in an investment does not necessarily mean that you will be compensated for it in terms of higher expected returns.

- The data on historical returns for stocks and bonds show that over the past 90 years, large-capitalization stocks had an average annual return of 12.1%. But that's a measure for entire portfolios of securities. Suppose that you invested all your money in only one successful large-cap company, such as General Electric or Apple. Should you expect to earn 12.1% on your investment? The answer is no.

- It makes common sense that if you put all your eggs in one basket, you are assuming a tremendous amount of very specific risk—the risk that one company will do very well or very poorly. And any single company will experience long periods of time when it either significantly outperforms or significantly underperforms the market.

- This sort of company-level risk is often called *diversifiable risk*.
  - Imagine that instead of putting all of your money in Apple stock, you put only half in Apple and the other half in General Electric. With this strategy, you have reduced, at least in part, your investment risk. But you have not reduced the overall expected return of your portfolio if historical returns for large-capitalization stocks prove accurate in the future.

  - The significance of this seemingly straightforward point cannot be overstated. You can diversify away specific risk—the risk that any one company will perform particularly well or particularly poorly. This is opposed to market or systematic risk, which affects all stocks and all companies and is related to such factors as interest rates, employment levels, and tax policy.

  - Thus, when many stocks—at least 25 to 30 in different industries—are combined in a single portfolio, the firm-specific risks for each stock are averaged out and diversified away. Your portfolio will still be subject to market risk—the risk that the overall market might go down—but the impact of any one stock will be tempered by the influence of other stocks in your portfolio.

- Because volatility can be reduced fairly easily by adding different stocks to a portfolio, investors should not expect to be compensated with additional returns for that portion of volatility that is stock- or company-specific. Investors should expect to be compensated only for the risks that cannot be diversified away—systematic or market risk.

Beta

- *Beta* (β) measures how a particular security has historically co-varied with the overall market, usually measured by a broad-based stock index, such as the S&P 500 or Russell 2000.
    - Imagine that over an extended period of time, the stock market goes up or down by a particular amount while a particular stock goes up or down, on average, by half that amount. That is, if the stock market goes up by 1% on any one day, this particular company's stock goes up by 0.5%. That stock is then said to have a $\beta = 0.5$.

    - Or imagine a more volatile stock; when the market goes up or down by x, this stock varies by double that amount. It has a $\beta = 2$.

    - Of course, if you own an equal share of all stocks in the market, your expected return would be that of the overall market, and your portfolio would have a $\beta = 1$.

- Beta is a useful and powerful tool because it allows us to think about how individual assets are expected to move in relation to the overall market, which can help us craft an appropriately diversified portfolio. Beta also helps us understand the risks that are associated with any individual company. Given what we know about the historical returns of the overall market, we can estimate the future returns associated with individual stocks within a diversified portfolio.

Capital Asset Pricing Model

- Quantifying the relationship between historical and future returns was a tremendous advance in finance and modern portfolio theory and led to an extremely important model in finance, the capital asset pricing model (CAPM).

- To develop an intuition for CAPM, let's imagine three securities.

- The first has no volatility at all; there is no relationship between the way this security moves and the overall performance of the market. This investment might represent, for example, the money in an insured bank account. Clearly, the return on such an investment has nothing to do with how the stock market performs. We would therefore say that this security has a $\beta = 0$ and an expected return of the risk-free rate. That return will be fairly low, but such is the trade-off for assuming such low risk.

- The second security moves in perfect lockstep with the market. It has a $\beta = 1$, and its expected return would equal that of the overall market.

- The third security moves up or down at a rate twice that of the overall market, which means it has a $\beta = 2$. We would expect this security to earn returns superior to those of the overall market to compensate us for taking on the additional risk of a significant loss on our investment.

- If we put these three data points into a mathematical formula, the result is CAPM, which concludes that the expected return of any investment in a well-diversified portfolio is equal to: Risk-free rate + β(Expected market return − Risk-free rate).

- Essentially, CAPM says that any asset should be expected to earn, at a minimum, the risk-free rate and some premium for assuming additional risk. This additional risk is made up of two factors: the asset's beta and the equity risk premium, which is the amount that the overall market is expected to earn above the risk-free rate.
  - If you put a certain amount of money into a diversified portfolio of, say, 30 stocks in different industries, you know that this portfolio, although diversified, is still more risky than owning a risk-free U.S. treasury bond. And you should expect to be compensated for taking on that additional risk. Again, you may or may not receive that compensation because there is still some market risk in such a portfolio, but you should expect to earn some premium. This is known as the *equity risk premium*.

    - Academics have debated the amount of the equity risk premium, but today, most experts agree that it is between 5% and 6%. That is, if you invest in a portfolio of diversified stocks, you should expect to earn the risk-free rate, plus 5% or 6%.

- Assume you are considering adding a stock with a $\beta = 2.0$ to your already diversified portfolio. If the interest rate on 10-year U.S. treasury bonds is about 2.50% and the equity risk premium is 5.0%, you would calculate the expected return from this stock as follows: 2.5% + 2(5%) = 12.5%.

Using CAPM

- There are two broad types of investing: active and passive. Passive investors try to match the market, not beat it, while active investors try to "beat the market" by picking winners. With CAPM, we can examine an active fund manager's portfolio; determine the risk that he or she took, as measured by beta; and use that beta to predict how the manager should have done relative to the market.

- Let's say that a particular fund manager's portfolio had a weighted average beta of 1.20 during a particular year.
    - We would expect this fund to move by 20% more than the overall market in either direction. That is, if the overall stock market went up by 10% during the year, we would expect this fund to have gone up by 12%.

    - If the fund manager's portfolio went up by 15%, we would conclude that this manager added additional value from his or her selection of stocks—an additional 3%. That additional value is called *alpha*.

- In recent years, a great deal of research has gone into the predictive ability of CAPM. When actually realized returns are compared to what CAPM would have predicted, we find that the model is able to account for about 85% to 90% of the price movements that historical betas would have anticipated. Academics in finance and

economics have also spent considerable time trying to refine CAPM and improve its predictive abilities by adding variables and testing whether they add to the model's predictive power.

- Perhaps the most well-known of these models is the Fama and French three-factor model. In addition to the beta factor, the renowned researchers Eugene Fama and Ken French found two more factors that improved CAPM's predictive capabilities: a stock's *value* and the *size* of the company.

- Value is determined by comparing a company's shareholders' equity to its market capitalization, essentially the company's value on the stock market. The size of the company is represented by its market capitalization.

- For example, if a stock has a book value or shareholders' equity of $1 billion and a market capitalization of $500 million, it would appear to be a good value; a buyer is paying a discount for the company's reported net assets.

- Fama and French determined that there was a positive relationship between expected returns and this value factor. This seems intuitive: If you are buying a stock at what appears to be a discounted price, you should in turn expect a higher return. And the opposite is also true. If the stock market is valuing a company at multiples of what it is reporting as assets on its balance sheet, it appears that you are buying in at a premium; therefore, your expected return looking forward should be lower.

Suggested Reading

Brealey, Myers, and Allen, *Principles of Corporate Finance*, chapters 7–8.

Easton, McAnally, Sommers, and Zhang, *Financial Statement Analysis and Valuation*, chapter 12.

Questions to Consider

1. Most financial advisors recommend that younger individuals put most, if not all, of their retirement assets into stocks, then reduce their exposure to stocks as they near retirement. Why?

2. Assume that the risk-free rate, the yield on 10-year treasury bonds, is 3.0%, and you invest some of your well-diversified stock portfolio into a company with a beta of 1.15. Assuming that the equity risk premium—the amount by which the stock market is expected to outperform risk-free rates—is 5.0%, what is the return you anticipate from this investment, according to CAPM?

How Investors Use Net Present Value

Lecture 33

In this lecture, we will discuss several approaches used for evaluating investment opportunities: the payback method, the accounting or book rate of return, and net present value (NPV). Along with CAPM, which we introduced in the last lecture, NPV may be the most important mathematical formula in finance. It combines several of the concepts we have discussed thus far, including the time value of money, expected rates of return, and risk. As we'll see, NPV integrates these ideas into a powerful investment decision-making tool with widespread applications.

Structure of Investment Opportunities

- All investment opportunities are essentially structured in the same way: An upfront investment is made today in anticipation of some uncertain cash flows or returns in the future. This is true of a firm making a capital budgeting decision, a charitable organization deciding how to spend its limited resources, or an individual investor deciding whether to purchase a particular stock

- To make smart and value-creating investment decisions, the future returns or cash flows, which are worth less than the dollars expended today, must exceed the amount invested. That is, the present value of the projected future inflows must be greater than the present value of the outflows. This is essentially the definition of *net present value* (NPV).

Payback Method

- Before we delve further into NPV, let's start with a common approach to investment decision making: the payback method. This approach essentially answers the following question: If you make an investment of $*X* today, how long do you have to wait until you recoup your investment?

- For example, if you invest $10,000 and you expect the investment to return $1,000 each year after taxes, the payback period would be 10 years. A $100,000 investment that returns $20,000 each year, on average, would have a five-year payback. All else equal, the shorter the payback period, the better the investment opportunity. Some firms establish maximum allowable payback periods against which investments should be compared.

- The payback approach is widely used for several reasons. It is fairly simple, easy to apply, and relatively intuitive. We all understand that if we invest in something, a payback within a few years would generally make sense.

- However, there are also some serious deficiencies to the payback approach. After all, the goal of any investment is not just to get your money back but to make a profit. The payback method ignores cash flows after the payback period and ignores the time value of money. Moreover, the maximum acceptable payback period is usually arbitrary, reflecting some policy decision established in the past. Thus, the payback method is not an effective way to assess investment opportunities.

Accounting or Book Rate of Return

- Another method for evaluating investment opportunities is known as the accounting or book rate of return. As we've discussed, when companies report to shareholders, much of the focus is on the income statement, especially revenues, net income, and earnings per share. Cash flows, although certainly important, are usually not given as much emphasis in quarterly and annual earnings releases. As a result, some financial managers might use book accounting data to assess and evaluate investment opportunities, instead of cash flows, contrary to what finance theory tells us they should be doing.

- For example, imagine a company operating at capacity that is considering a $10 million investment in new machinery that would increase productivity and create value for the company and its shareholders. The current machinery, although outdated, is still functional and in use, but it has been fully depreciated and, therefore, has no value on the company's balance sheet. If the CFO were strictly looking at an accounting ROI, any return that the old machines produce would appear to be infinite. That is, the income generated by the machines would be made on something with no accounting value—the depreciated machines. Any positive income divided by zero will look great.

- However, this is a flawed approach because it is based on financial accounting metrics, which include non-cash depreciation expense. This has caused a significant difference between the accounting value of the equipment under GAAP and its true economic value, which should be based on actual cash flows and true market values. Therefore, it is imperative that we look at cash flows, not financial accounting metrics, to determine whether an investment might be value-creating.

NPV Formula

- A more robust, reliable, and effective means of evaluating investment opportunities than the payback or accounting rate of return approaches is NPV. The NPV is the sum of all the individual outflows and/or inflows related to any investment, with each of the individual cash flows discounted to its present value.

- Recall that in order to put future cash flows into today's dollars, we must discount them, which requires three inputs: (1) the amount of the cash flow, (2) the relevant interest or discount rate, and (3) the time period over which the discounting is to take place. Also recall the basic present-value formula for an individual lump sum:

$$\frac{CF_t}{(1+i)^t}.$$

- As an example, suppose that you expect to receive \$100 two years from today at a discount rate of 5%. What's the present value of that \$100? Plugging in the numbers, we get:

$$\frac{\$100}{(1.05)^2} = \$90.70\,.$$

- We then plug the present value of future cash flows into the NPV formula:

NPV = Present value of future cash flows (CF_t) − Initial investment required (CF_0)

$$\text{NPV} = -CF_0 + \frac{CF_1}{(1+i)^1} + \frac{CF_2}{(1+i)^2} + \frac{CF_3}{(1+i)^3} \ldots + \frac{CF_t}{(1+i)^t}$$

Assessing an Investment

- Let's walk through an example together. Assume that a small regional hospital is considering three mutually exclusive investments in different types of medical equipment: a surgical robot, an MRI machine, and a dialysis machine. Each of these will require an upfront investment of \$1.5 million, and each is of equal importance to the hospital's strategy.
    - Based on input from key personnel, the chief financial officer (CFO) of the hospital has created a table that projects year-end cash flows for each of the potential investments:

Year	Robot	MRI	Dialysis
0	(\$1,500,000)	(\$1,500,000)	(\$1,500,000)
1	\$200,000	\$300,000	\$500,000
2	\$300,000	\$400,000	\$500,000
3	\$400,000	\$600,000	\$500,000
4	\$500,000	\$650,000	\$500,000
5	\$650,000	\$750,000	\$500,000

- Each of the three opportunities will cost the same amount upfront, each has different projected cash flows over time, and each has no expected value after five years.

- Assume that the hospital requires a 10% return on whichever investment it decides to make.

- For all three opportunities, the initial cash outflow is $1.5 million. Because it is an outflow, it is a negative value in the NPV formula.
  - Starting with the surgical robot, the CFO's table indicates that the anticipated future cash flows are $200,000 in year 1, with some steady increases over time, to $300,000, $400,000, $500,000, and $650,000. But we know that the value of $650,000 in year 5 is far less than $650,000 in today's dollars, because it won't be realized until five years out and because of the 10% discount rate—the rate we want to earn on the investment.

  - If we plug $650,000 into the present-value formula, the result is $403,599. That's what those year-5 cash flows are worth in today's dollars.

  - The following table shows the present value of each of the projected cash flows for the robot:

	Year					
Surgical Robot	0	1	2	3	4	5
Year-end cash flow	($1,500,000)	$200,000	$300,000	$400,000	$500,000	$650,000
Present value @ 10%	($1,500,000)	$181,818	$247,934	$300,526	$341,507	$403,599
NPV	($24,616)					

  - As you can see, if we add up the present values of each of the individual cash flows, including the upfront $1.5 million investment, we get a negative result: −$24,616. The surgical robot investment has a negative projected NPV. If the hospital requires a 10% rate of return, it should not invest in the robot.

- The following tables show the NPV for the MRI machine and the dialysis machine:

	Year					
MRI	0	1	2	3	4	5
Year-end cash flow	($1,500,000)	$300,000	$400,000	$600,000	$650,000	$700,000
Present value @ 10%	($1,500,000)	$272,727	$330,579	$450,789	$443,959	$434,645
NPV	($432,698)					

	Year					
Dialysis	0	1	2	3	4	5
Year-end cash flow	($1,500,000)	$500,000	$500,000	$500,000	$500,000	$500,000
Present value @ 10%	($1,500,000)	$454,545	$413,223	$375,657	$341,507	$310,461
NPV	$395,393					

- If an investment opportunity has a positive NPV, it is an investment worth making. It is one that is expected to create value because, in simplest terms, the present value of expected cash inflows exceeds the expected cost of the investment. If, on the other hand, the NPV is less than 0, the investment is not worth making because it will destroy value, with expected future cash flows that do not provide adequate compensation for the original cost of the investment and the risk involved.

- Both the MRI and the dialysis machines have positive NPVs, but the MRI is the better investment because it has the higher NPV.

Rules for Calculating NPV

- There are several general rules to keep in mind when calculating the NPV of any investment opportunity. The first of these rules is that sensitivity analysis is important. Any quantitative model's output is only as good as its inputs.

- The second rule is that after-tax cash flows are normally the relevant item to discount for most organizations.

- The third rule is that these concepts can apply to those entities, such as philanthropic organizations, that are concerned with outcomes other than cash flows generated.

- The fourth rule is that when applying the NPV formula, we should consider only incremental cash flows in the numerator of the formula.
    - For example, assume that a company with several operations in the southeast is considering opening a new facility in California but will continue operating its other business units. Which cash flows should be considered in evaluating the new business proposition?

    - The answer is only the incremental cash flows, the amount to be invested in the new operations and the additional net cash inflows that are expected to be earned from the new location.

- Finally, we must treat inflation consistently. That is, our projected cash flows should be nominal, not discounted for inflation. After all, that is the point of discounting: to put future nominal cash flows into today's dollars. If we put future cash flows into today's dollars, then discounted them for inflation, essentially, we would have double-counted.

Suggested Reading

Brealey, Myers, and Allen, *Principles of Corporate Finance*, chapters 5–6, 10.

Mayo, *Basic Finance*, chapter 8.

Questions to Consider

1. Following the 2008 financial crisis, the U.S. Federal Reserve made a conscious decision to reduce interest rates to spur the economy and promote recovery. Keeping the NPV formula in mind, how would the Fed's policy actions promote its economic objectives?

2. Imagine that you have the opportunity to invest in a single-family home in your neighborhood that is in need of some renovation. You believe that you could purchase the home for $225,000 but would need to invest $100,000 in repairs and upgrades to the house, including adding a second story. You think that the construction will take two years and that the $100,000 in costs would be spent evenly over that period of time. You also believe that you will be able to sell the home for $450,000 at the end of the two years, net of real estate commissions and other sales costs. Is this a positive NPV project at a discount rate of 10%? Would your answer change if the discount rate were 15%?

Steps for Applying the NPV Formula

1. Estimate the total upfront costs of the investment, usually consisting of the purchase price, commissions, taxes, and the like.

2. Estimate the future cash flows expected to be derived from the investment over the relevant time period. If the investment has a finite life, such as a piece of machinery or equipment, estimate the cash flows over that particular period of time. If the investment is considered to be a perpetuity, such as an investment in a new business, a piece of real estate, or a stock, estimate what you think it will be worth at some future point in time, say, in 5 or 10 years.

3. Assess the riskiness of the cash flows.

4. Determine the appropriate discount rate and compute the NPV. If the result is negative, it's probably wise to avoid the investment.

5. Sensitize the key inputs—the projected cash flows and the discount rate—to construct base-case, best-case, and worst-case scenarios.

6. Make the investment decision.

Alternatives to Net Present Value

Lecture 34

In this lecture, we will discuss several other metrics for evaluating investment opportunities: internal rate of return (IRR), the profitability index (PI), and equity multiples. Although NPV is certainly the most robust method for conducting such evaluations, it is not as widely used in the real world as the IRR or equity multiples, both of which are easier to understand. However, as we will see, these other approaches should not take the place of the more analytical NPV approach. The wisest course in evaluating investments is to compute the NPVs on projected cash flows, along with the appropriate discount rate, that is, the rate of return you think should compensate you for the risk you are taking.

NPV and IRR

- As we saw in the last lecture, NPV is the sum of the present values of any cash outflows required for a particular investment, plus the present value of future cash inflows, such as dividends, interest, rents, or other income. Again, all the anticipated cash flows over time, both in and out, are restated in today's equivalent dollars, using a discount rate, which is an interest rate based in part on the riskiness of the particular investment. If the NPV is greater than 0, the investment will create value. If the NPV is negative, the investment can be expected to destroy value.

- As useful a tool as NPV is for evaluating investment opportunities, it has some practical limitations and challenges when applied in the real world. One of the difficulties is determining the proper discount rate to use when computing the present values for the cash flows an investment is expected to generate over time. Further, it is difficult to interpret what NPV means beyond telling us whether we should or should not make a particular investment. Investors usually want more information, including the rate of return on the potential investment.

- As a result of these shortcomings, some industries use a return measure known as internal rate of return (IRR). Mathematically, IRR is the discount rate at which the NPV is equal to 0—sort of a breakeven discount rate.
  - As we've discussed, NPV is:

    NPV = Present value of future cash flows (CF_t) − Initial investment required (CF_0)

$$\text{NPV} = -CF_0 + \frac{CF_1}{(1+i)^1} + \frac{CF_2}{(1+i)^2} + \frac{CF_3}{(1+i)^3} \ldots + \frac{CF_t}{(1+i)^t}$$

  - To find the IRR, we set the NPV equation equal to 0 and solve for the missing variable, *i*.

Calculating IRR

- Imagine that you've been offered the chance to invest with some partners in a piece of income-producing real estate, perhaps a duplex that needs to be renovated and resold.
  - The initial down payment required is \$100,000, which includes the budget for renovations; you will borrow \$200,000 from a bank to complete the purchase.

  - You estimate that the investment will generate net income before taxes of \$8,000 in each of the next three years, including interest payments to the bank. At the end of the three years, you think the investment will be worth \$320,000, at which point you will pay back the loan of \$200,000, leaving \$120,000 to distribute to the partners.

- With a discount rate of 8%, the NPV of this investment would be calculated as follows:

$$\text{NPV} = (\$100{,}000) + \frac{\$8{,}000}{1.08} + \frac{\$8{,}000}{1.08^2} + \frac{\$128{,}000}{1.08^3}$$

NPV = \$16,582

- The result is clearly positive; thus, you can anticipate that this will be a good investment, one that will earn over 8%. But what if you are unsure about the discount rate to use and want to know the actual rate of return on the investment? To address those questions, you need to calculate IRR. For this calculation, again, you're solving for a particular discount rate in the NPV equation; to do that, you set NPV equal to 0.

$$0 = (\$100{,}000) + \frac{\$8{,}000}{(1+x)} + \frac{\$8{,}000}{(1+x)^2} + \frac{\$128{,}000}{(1+x)^3}$$

  The unknown discount rate is about 14.1%.

- As a rule, if the IRR from an investment opportunity is greater than the rate of return you require on the investment, you should proceed with the opportunity. If the IRR is less than the required rate of return, you reject it. For example, if you determine that a project has an IRR of 13% (NPV = 0 at a 13% discount rate), you make the investment so long as you require less than a 13% return for that particular opportunity.

- Unfortunately, for investment opportunities lasting more than two periods, it is not possible to solve algebraically for the IRR using the discounted cash flow equation. As a result, there are three ways to calculate IRR:
  - Trial and error. Simply try different discount rates until one yields an NPV equal to 0.
  - Graph the function. Calculate the first few guesses of a trial-and-error approach. Graph these, then extrapolate to the point where the graph crosses the NPV = 0 line to yield an approximate IRR.
  - Use a financial calculator or computer spreadsheet.

Limitations of IRR

- Although IRR is widely used and cited, it has some significant drawbacks, one of which is the size problem.
  - Consider, for example, an investment opportunity with a 100% IRR. That sounds wonderful, but what if the investment requires only $10? It's still a good deal, but not many investors will get excited about it.

  - Would you rather invest $10 and get back $20 or invest $10,000 and get back $13,000? The latter has a lower IRR—a mere 30% compared to 100% in the first opportunity—but most of us would be far more interested in the latter investment than the former.

  - With NPV, we don't have this problem because it takes into account the actual amounts of cash inflows and outflows.

- Another shortcoming of IRR is a bit more complex. To understand it, consider this question: Which investment would you prefer, one that earns 10% and lasts for one year or one that earns 8% each year for a total of four years?
  - Longer-term cash flows may have lower IRRs, but many of us would prefer to make such investments to avoid *reinvestment risk*.

  - Because the IRR is expressed only as a percentage, it says nothing about the duration of the investment.

- Yet another shortcoming of the IRR has to do with mathematics. Some investments, especially in a corporate context, have negative cash flows for long periods of time. They might require research and development, for example, or extensive construction. In other cases, you may have an investment that generates cash flows at some times and requires investment of cash at other times. The problem in these situations is that you may get multiple answers to the IRR equation.

    - When you receive cash flows from an investment, you get to reinvest them, of course. The IRR approach assumes that you can reinvest these cash flows in other projects earning the same rates of return as the current project, which may or may not be true. However, when you have to spend money on an investment you already have, you are essentially lending money to the project. Although the NPV formula can handle projects that both throw off and require cash, the IRR formula cannot.

    - This makes IRR a popular and common method for analyzing venture capital and private equity investments. These investment strategies usually require cash investments throughout their lives but only one cash inflow at the end of the project, perhaps an initial public offering or a sale of the asset to another investor or firm.

- Finally, IRR does not help us compare two mutually exclusive investment opportunities.
    - Consider two potential projects: The first requires an investment of $10,000 and is expected to return $12,000 in a year. The second requires an investment of $1,000 and is expected to return $2,000 in a year. The first has an IRR of 20%, and the second, an IRR of 100%. Should you jump on the second opportunity? The answer is no because the first has a higher NPV, equal to $909, versus the second, which has an NPV equal to $818.

    - The IRR leads to the wrong decision here because it does not take into account the different scales of the projects. The larger project has a smaller percentage return but a larger dollar return. The NPV formula picks this difference up, but the IRR does not.

Profitability Index

- The profitability index (PI) is defined as the NPV of an investment opportunity divided by the amount of the initial investment. We can think of it as the “bang for the buck” metric. As a CFO weighing

investment options for your company, you might use the PI to rank various alternatives under consideration. Then, working from the highest-ranked opportunity to the lowest, you can invest in one project after another until all the available funds are expended.

- Let's work through an example. Imagine that a certain organization has a budget for capital projects of $2 million this year, and the CFO has five potential projects in which to invest. The NPV, required investment, and PI for each of the projects is shown below.

Project	NPV	Investment Required	PI
A	$90,000	$900,000	0.100
B	$125,000	$1,100,000	0.114
C	$65,000	$500,000	0.130
D	$25,000	$500,000	0.050
E	$60,000	$400,000	0.150

- Ranked by PI, these projects would fall into the following order: E, C, B, A, and D. Thus, the CFO could start with E, which requires an investment of $400,000 and would leave $1.6 million left to spend. Next would be project C, which requires $500,000 and leaves $1.1 million. Project B would use up the remaining $1.1 million of investment capital, while projects A and D would have to be reconsidered at some future point in time.

Equity Multiples

- The equity multiple is commonly used in private equity and venture capital investments. It is calculated by dividing the cumulative amount of returns paid to an investor over time by the capital invested.

- Assume that you invest $50,000 in a venture capital fund, and over the five-year life of the fund, you receive a total of $125,000 in distributions. Thus, the equity multiple is: $125,000/$50,000 = 2.25.

- Obviously, the time value of money is ignored under this approach, which differentiates the equity multiple from other valuation methods. But the method is simple, and for certain types of investments that are relatively short in duration, such as private equity or venture funds, it can be a reasonable way of comparing different funds or fund sponsors.

Suggested Reading

Brealey, Myers, and Allen, *Principles of Corporate Finance*, chapters 14, 17–18.

Collins, Johnson, Mittelstaedt, Revsine, and Soffer, *Financial Reporting and Analysis*, chapter 11.

Easton, McAnally, Sommers, and Zhang, *Financial Statement Analysis and Valuation*, chapter 12.

Questions to Consider

1. Using trial and error, can you approximate the IRR for a three-year investment with the following estimated year-end, after-tax cash flows:

Initial Investment	Year 1	Year 2	Year 3
$25,000	$2,000	$3,000	$27,000

2. A firm specializing in mergers and acquisitions purchases a privately held company for $250 million. In the three years following the acquisition, the company is able to pay dividends of $40 million, $45 million, and $50 million to the buyout firm. At the end of the three years, the buyout firm sells the company to a larger industry player for $350 million. What is the equity multiple for this transaction?

Weighing the Costs of Debt and Equity

Lecture 35

In order to fund operations and necessary capital expenditures, firms turn to any number of potential sources, including borrowing money from a bank or other financial institution, issuing notes or bonds to investors, and selling shares of stock in the firm. Some firms issue convertible bonds, a hybrid security that is a combination of a bond that pays interest, along with a so-called "equity kicker," a potential or contingent interest in the issuer's stock. Many firms use a combination of all these approaches to raise necessary funds. In this lecture, we'll look at the trade-offs between issuing debt versus equity and explore the accounting, finance, and valuation implications of such decisions.

Debt versus Equity

- In 1958, two academic researchers, Merton Miller and Franco Modigliani, published a paper entitled "The Cost of Capital, Corporation Finance and the Theory of Investment." The premise of their work was that the value of any firm is independent of how it finances its business. That is, whether a firm finances its business entirely with debt, entirely with equity, or with some combination of the two is irrelevant in that the value of that firm will not change.
    - Although this theorem sounds simple, it is considered a cornerstone of corporate finance and has spawned significant additional research.

    - Despite the theory, however, the decision to issue debt, stock, or a combination of the two can, in fact, affect the overall value of a firm. By changing the capital structure of a firm, its value may increase or decrease, depending on circumstances.

- A fundamental concept in finance is this: The cost of debt is cheaper than the cost of equity. Investors in a company's bonds expect a lower return than investors who purchase stock in the same company, all else equal.

- Generally speaking, when investors purchase a company's bond, they anticipate receiving periodic payments of interest and a repayment of the bond's principal when it matures. For example, in 2013, Apple issued 10-year standard bonds. Anyone who purchased one of those bonds expected to receive 2.415% in interest each year, in addition to the principal amount of the bond when it matures. There is no additional return to this investment.

- In contrast, investors who purchase a company's common stock understand that there will be much more variability in the ultimate outcome. And because of this additional risk, investors expect to be appropriately compensated.
    - Although debt almost always requires periodic payments of interest, dividends on stock are not mandatory; they are issued at the discretion of a company's board of directors. But because a share of common stock represents an actual ownership interest in the company, there is no ceiling on the return that an investor might earn.

    - If Apple stock goes up 20% this year and continues to pay dividends, the company's stock owners will have done much better financially than the bond owners. Of course, the flipside is also true. Thus, stocks are more risky than bonds, and investors expect a higher return for owning them.

- Moreover, in the event of the insolvency of a firm, debt has preference over equity in bankruptcy proceedings. In such cases, stockholders usually lose all their investments in the firm. Although bondholders may also get hurt by these events, their losses are somewhat buffered by the fact that they receive preferential treatment. Thus, bondholders receive lower expected returns than stock or equity holders, simply because they assume less risk.

Other Debt and Equity Considerations

- A second significant difference between debt and equity is that interest payments to bondholders are tax deductible while dividends paid to shareholders are not. Our government subsidizes the issuance of debt by providing firms with a tax deduction for interest expense. This economic carrot can be quite significant and definitely encourages increased borrowing and leverage.
    - For example, consider a firm with a 30% combined state and federal tax rate that issues 6% bonds; the company can deduct 30% of the total amount it pays on those bonds. The after-tax cost of the bonds is actually 70% of the 6% rate, or 4.2%. This is not an insignificant difference.

    - Thus, at the margin, if a firm is deciding whether to issue debt or stock, the value of the firm can be affected by the value of the tax shield derived from the interest deductions over time.

- If debt is cheaper than equity and is tax favored, why don't firms just issue debt instead of stock, thereby increasing the value of the firm? One answer is that unlike equity, debt has a maturity date and must be repaid. Debt also typically requires periodic payments of interest. As firms continue to pile on debt, the risks related to the firm's potential insolvency outweigh the benefits of the additional debt.

- Another fundamental difference between debt and equity relates to corporate governance and control. Shareholders can elect a company's directors and approve certain matters regarding executive compensation, mergers and acquisitions, and so forth. Retail shareholders do not usually hold enough shares to sway elections, but they still get to vote, while bondholders typically do not. Usually, this would not have an impact on valuation, but it might if a significant number of voting shares in a corporation is held by one or a few individuals.

Costs of Debt and Equity

- As we noted, debt generally requires periodic tax-deductible interest payments. The cost of debt, K_d, is calculated with the following formula: $K_d = i(1 - t)$, where i is the interest rate on the debt and t is the tax rate.

- The cost of equity, or K_e, is trickier because it is equal to the expected return that an equity investor anticipates from owning stock, and this expected return is, in turn, derived from asset-pricing models, such as CAPM.
    - As you recall, the CAPM formula is: Expected asset return = Risk-free rate + β(Expected market return − Risk-free rate). In discussing the cost of equity, the formula is written as follows: $K_e = R_f + (\beta \times \text{Equity risk premium})$.

    - Assume, for example, that the 10-year treasury yield is 2.6%, a company's beta is 1.5, and the equity risk premium is 5%. In this scenario, the company's cost of equity would be: 2.6% + (1.5 × 5.0%) = 10.1%.

Weighted Average Cost of Capital

- Most capital projects or investments are financed with a combination of debt and equity. To compute their costs, we use the weighted average cost of capital (WACC).

- As an example, assume that you plan to purchase a home for \$500,000; you will put \$100,000 down and borrow the remainder, \$400,000. The \$400,000 mortgage has an interest rate of 4% before taxes. To fund the \$100,000 down payment, you sold some stocks, which you

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Borrowing money is often part of an investment decision, both in business and in our personal lives.

estimate would have continued to earn 10% after taxes if you hadn't sold them. Your combined state and federal tax rate is 25%. What is your WACC for this transaction?

- You took out a 4% loan for 80% of the home's purchase price, but remember that the 4% interest is tax deductible. Thus, the after-tax cost of debt is actually 4% × (1 − 25%), or 3%.

- Meanwhile, the cost of equity is the opportunity cost related to having money tied up in the house as opposed to the stock market. You estimated that to be 10% after taxes.

- Clearly, the cost of the mortgage debt is cheaper than the cost of the down payment, or equity. If you had sold $500,000 worth of stock to make the purchase, ignoring any possible capital gains to be paid, the after-tax cost of the transaction would be 10%; thus, the relevant cost of equity would be 10%. In contrast, if you had borrowed 100% of the purchase price of the house, the relevant cost of capital would be just 3%.

- However, as mentioned, we normally purchase houses using both debt and equity, each with its own unique cost. Therefore, we need to compute the WACC for funds used in such transactions.

- In the case of the $500,000 home purchase, the WACC would simply be 80% × 3% for the debt component, plus 20% × 10% for the equity component; that yields: 2.4% + 2.0% = 4.4%.

- The WACC is important for three reasons: (1) It highlights the different costs of debt and equity, taking taxes into account; (2) it reflects the reality that capital investments usually employ a mix of debt and equity; and (3) it provides the appropriate discount rate to be used in computing NPVs to evaluate capital projects. That is, for any capital project to create value, it must earn more than the WACC used to make the investment.

- The formula for WACC is as follows:

$$K_e\left(\frac{E}{V}\right)+\left(K_d\left(1-t\right)\right)\left(\frac{D}{V}\right)$$

Where:

K_e = cost of equity
K_d = cost of debt
E = market value of firm's equity
D = market value of firm's debt
$V = E + D$
t = corporate tax rate

Using WACC

- We can use the WACC formula to estimate the cost of capital for an entire company. For example, below are some salient figures regarding IBM (using 2014 data):
    - The company has long-term debt outstanding of about $46.5 billion.
    - Based on its most recent debt offering, IBM's pretax cost of debt is 3.625%.
    - The company's overall tax rate is 20%.
    - IBM's stock market capitalization is about $190 billion.
    - Finally, IBM's beta is 0.7.
- The last two pieces of information we need are the risk-free rate, which is the yield on 10-year treasury bonds, and the overall equity risk premium, which is the amount we expect the stock market to outperform risk-free investments. Let's assume a risk-free rate of 2.5% and an equity risk premium of 5%.

- To compute IBM's overall WACC, we begin by computing the company's after-tax cost of debt: 3.625% × (1 − 20%) = 2.9%.

- To compute the estimated cost of equity, we use CAPM. We start with the risk-free rate, here, 2.5%, and add to it the beta-weighted equity risk premium, here, equal to 0.7, multiplied by 5%. Thus, the cost of equity is estimated to be: 2.5% + (0.7 × 5.0%) = 6.0%.

- Finally, once we have estimated the costs of both the debt and the equity, we can compute the WACC based on the relative values of each that IBM has in its current capital structure.
    - First, we add the company's debt, $46.5 billion, and the market value of its common stock, $190 billion. The total is $236.5 billion.

    - Dividing $190 billion by $236.5 billion, we see that equity represents 80.3% of the company's capital structure. Therefore, debt represents 19.7% of IBM's capital structure.

    - The WACC is, thus, 80.3% × 6.0% (the cost of equity) + 19.7% × 2.9% (the after-tax cost of debt). The result is about 4.8%. This would be the appropriate discount rate IBM might use today if it was funding a capital project using both 10-year bonds and some equity, in about 80-20 proportions.

Suggested Reading

Brealey, Myers, and Allen, *Principles of Corporate Finance*, chapter 5.

Mayo, *Basic Finance*, chapter 8.

Questions to Consider

1. As the owner of a successful fast-food franchise, you have been offered the opportunity to open a second location in a neighboring community. However, opening the second store will not be inexpensive; you estimate the total capital commitment to be $200,000. Your local bank has offered to loan you $120,000 for five years at a cost of 6.5% each year. You would need to sell some stock and borrow against your life insurance policy for the remaining $80,000 needed, and historically, these other investments have increased by 11% each year. You expect that your combined federal and state tax rate will average 25% over the next several years. What is the WACC for this investment?

2. Using the WACC computed above, assume that you expect the new location to generate after-tax cash flows of $20,000 per year for each of the next five years (at the end of each year) and that the location will be worth $235,000 at the end of the five years. What is the NPV of the investment? Should you open up this new location?

How to Value a Company's Stock

Lecture 36

As we've said throughout these lectures, investors should strive to make value-creating investment decisions. In finance terms, we've described a value-creating investment as one that has a positive NPV, where the benefits received from the investment over time exceed the amount invested, all viewed in today's dollars. When investors and capital providers lose sight of this fundamental principle, economic catastrophe may ensue. Thus, in our final lecture on finance and accounting, we'll keep a close eye on the fundamentals. In particular, we'll see how many of the tools we've already discussed can help us determine whether a particular stock might be under- or overvalued.

Reviewing Terms

- Let's begin by reviewing some definitions, starting with EBITDA. This metric is most easily calculated by starting with a company's operating income and adding back depreciation and amortization expense.

- A second important term is free cash flows, that is, the cash flows generated from a firm's normal and recurring operations, less what it spends on capital expenditures.
    - This definition is perhaps the most critical one for stock valuation because the residual cash that a firm generates after investing in its own business should support its stock price. That is, when you purchase a stock, you are really purchasing a share of a company's future free cash flows.

    - One key attribute of free cash flows is that they should be unlevered, free of the impact of any debt or leverage a company might have.

- The third definition we need to review is market capitalization, the total stock market value for a particular company. It is calculated by multiplying the total number of shares of outstanding stock by the stock price.

- The last definition we need is enterprise value. This is the sum of the market value of a company's equity and the market value of the company's net debt—its long-term debt less its cash. If a company has $100 million of long-term debt outstanding and cash in the bank of $60 million, its net debt is $40 million. If a company has a market capitalization of $200 million and net debt of $40 million, its enterprise value is $240 million. Enterprise value reflects the total market value of a firm—the minimum amount a buyer would have to pay to purchase the firm.

Fundamental Analysis

- The general approach to valuing stocks is known as *fundamental analysis*, which entails an examination of quantitative and qualitative factors that might affect a company's value. These might include the company's financial statements and ratios; its projected free cash flows; its management team, strategy, and competition; and even macroeconomic factors—all evaluated in the context of what a company is selling for in the marketplace. The goal of fundamental analysis is to determine whether a stock is undervalued or overvalued.

- For valuation, it's important to review a company's market capitalization and enterprise value compared to accounting data or an accounting metric. Some common valuation metrics involve the price-earnings ratio, as well as price-to-sales and price-to-EBITDA ratios. Once these ratios are calculated for one company, they are compared to the ratios of other companies in the same industry.

- Let's walk through an example, using Apple. As of mid-2014, Apple had about 6 billion shares outstanding and a stock price of about $100 a share. Its market capitalization was, therefore, about $600 billion. Apple also had debt outstanding of $29 billion and cash and liquid securities of nearly $165 billion.

- Given these metrics, Apple's enterprise value is: ($600 billion + $29 billion) − $165 billion = $464 billion.

- To calculate Apple's price-earnings ratio, we divide its stock price by its earnings per share: $100/$5.96 = 16.8.

- To compute the price-to-EBITDA ratio, we divide the market capitalization by EBITDA: $600 billion/$59.1 billion = 10.2.

- We then would compare these ratios to the ratios of competitors; to broad market indices, such as the S&P 500; and to history. Collectively, these comparisons would enable us to make some judgments about whether Apple's stock appears under- or overvalued.

Discounted Cash Flow Analysis

- Perhaps the most important fundamental analysis used to value stocks involves discounted cash flow models, which integrate such concepts as free cash flows, the time value of money, discount rates, and the cost of a firm's capital.

- At the most basic level, any company should be worth the NPV of its expected future free cash flows. After all, when we buy a stock, we are purchasing a pro rata share in all of the future earnings and cash flows that company might generate. However, we know that future cash flows are worth less than current ones and that there is inherent uncertainty and risk in future cash flows. Thus, we need to think about how to appropriately discount them to put those projected future cash flows into their current equivalents.

- Discounted equity or stock valuation models involve several steps. The first step is to compute the company's free cash flows for the past few years by examining historical financial statements, primarily the statement of cash flows. The second step is to project future free cash flows based on historical analysis and intuition.

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Predicting future cash flows is especially challenging for technology firms, where new products are constantly being introduced and new competitors routinely emerge.

- In the long run, we expect companies to grow at some steady rate once they hit a certain size or level of sales. Most analysts and economists consider a growth rate of 3% to 5% a year to be reasonable once a company reaches a certain size.

- However, for some firms, especially those in technology, we assume stronger growth rates for a period, followed by more normal and modest growth rates. Of course, this depends on the specific company and the industry in which it operates.

- Once we have predicted the company's future free cash flows, we must discount them to present-value equivalents. To do this, we use the firm's WACC.

- At this point, we will have our best estimate of the present value of the company's expected future free cash flows, which is, in essence, an estimate of its overall value. We can then compare this

result to the actual enterprise value of the firm and make an initial investment conclusion about whether the company appears over- or undervalued.

- Before reaching a final conclusion, we should also step back and reflect on our analysis and assumptions. Perhaps our projected future cash flows are aggressive or overly conservative. We might modify our assumptions and projected growth rates to see how those adjustments change our conclusions.

Dividend Discount Model

- Let’s apply the steps in discounted cash flow analysis to a real-world enterprise, an electric utility called Southern Company. As of 2014, its common stock sold for about $45 a share, and it paid an annual dividend of $2.05 per share. In the several years prior to 2014, Southern Company increased the dividend by about 3% to 3.5% each year.

- As a regulated utility company, Southern Company’s future growth will likely be modest, in line with the overall growth in the economy. Much of its return to shareholders will likely come in the form of cash dividends.

- What is Southern Company’s stock worth? Let’s assume that next year’s dividend will increase to about $2.10 a share. Let’s further assume a WACC of 6% and that future dividends will continue to increase by just 2% each year. Given these assumptions, can we use a discount model to estimate a value for Southern Company?

- Southern Company stock almost sounds like a growing perpetuity, an investment paying a dividend that is expected to increase each year. The shortcut for calculating the present value of a growing perpetuity is to divide the cash flow projected for the next year by the difference between the discount rate and the expected future growth rate:

$$\frac{CF_1}{(i-g)}.$$

Plugging in the numbers, we get:

$$\frac{\$2.10}{(6\% - 2\%)} = \$52.50.$$

This valuation approach is known as the *dividend discount model*.

- The problem with the dividend discount model is that many firms pay only modest dividends or no dividends at all. Therefore, we need a more robust discount model, one based on the company's overall projected free cash flows, discounted to present value. Because this approach provides an overall enterprise value, we will then need to back into what our model might tell us about the company's stock price.

Computing Free Cash Flows

- In an earlier lecture, we discussed a shortcut measure of calculating free cash flows: subtracting CAPEXs from a firm's operating cash flows. We also saw that this metric reflects the firm's leverage or debt and that we must unlever the operating cash flows as a first step. To do this, we add back to operating cash flows the amount of interest the company paid during the year after taxes.

- Let's walk through an example using Nike, the global athletic apparel company. For the 2014 fiscal year, Nike reported cash flows from operations of \$3 billion, CAPEXs of \$880 million, interest paid of \$53 million, and a tax rate of 24%.
    - To compute free cash flows, we start with cash flows from operations and add back the after-tax cost of interest Nike incurred during the year. Because Nike paid \$53 million in interest before taxes and because interest costs are tax deductible, we can estimate that Nike's after-tax interest cost was about \$40.3 million, or \$53 million × (1 − 24%).

- Thus, Nike's 2014 annual free cash flows were $2.16 billion, calculated as follows: $3 billion + $40.3 million − $880 million. Again, this figure represents the amount of cash Nike generated from operating and investing in its core business, assuming the company had no debt at all.

- Let's now do a discounted cash flow analysis to address the question: How much should Nike's stock sell for?
  - Because Nike is a large, established company, we can assume that it will continue to grow at a rate in line with the overall global economy, say, 4% annually. Thus, we would assume that Nike's fiscal 2015 free cash flows would be $2.25 billion—4% higher than 2014 free cash flows.

  - To value Nike overall, we need to compute this estimated 2015 free cash flow as a growing perpetuity:

$$\frac{\$2.25\text{ billion}}{\left(i-g\right)}.$$

Here, g, or the predicted annual growth rate, is 4%. If we assume Nike's WACC to be 6%, the company would be worth:

$$\frac{\$2.25\text{ billion}}{\left(6\%-4\%\right)}=\$112.5\text{ billion}.$$

- Valuing stocks integrates many of the concepts we have covered in these lectures. We start with free cash flows derived from accounting disclosures. We then consider the company's cost of capital and input its anticipated future growth rate. For stable and well-established companies, this exercise is fairly straightforward. For companies that are still growing rapidly, such as Tesla or Netflix, we would need to project future cash flows each year until they stabilize, then discount all future cash flows accordingly.

Suggested Reading

Brealey, Myers, and Allen, *Principles of Corporate Finance*, chapters 4, 19.

Collins, Johnson, Mittelstaedt, Revsine, and Soffer, *Financial Reporting and Analysis*, chapter 6.

Damadoran. *The Little Book of Valuation*.

Easton, McAnally, Sommers, and Zhang, *Financial Statement Analysis and Valuation*, chapters 12–13, 15.

Questions to Consider

1. You are considering investing in Home Depot stock but would like to compare the company's recent operating performance to its competitors. What are some companies that compete against Home Depot that you could use for comparison?

2. Assume the following for a potential company you are considering investing in. Further assume that the company has been in business for some period of time and operates in a fairly stable industry.

- Most recent annual cash flows from operations: $100 million
- Interest expense in most recent fiscal year: $25 million
- Projected annual growth rate in cash flows: 5%
- Tax rate: 35%
- Annual anticipated future capital expenditures: $40 million
- WACC: 7%

Based on this information, what is the company's estimated enterprise value (overall value)? How does the value change as the company's expected future cash flows increase? How does it change if the tax rate decreases? How does it change if the company's WACC increases?

Critical Business Skills: Organizational Behavior

Clinton O. Longenecker, Ph.D.

Critical Business Skills: Organizational Behavior

Scope:

We all work in all types of organizations: small, large, high-tech, not-for-profit, family businesses, entrepreneurial start-ups, public and government sector—just to mention a few. What makes working in organizations an interesting and, at times, challenging proposition is the fact that these enterprises are made up of human beings. And, of course, each of these human beings has his or her own unique personality, talents, motives, communication styles, and personal idiosyncrasies that can make going to work a blessing or a curse.

Human beings are social creatures, and human behavior within organizations tends to follow certain recognizable patterns. The field of organizational behavior was established to study those patterns and to develop practices for bringing out the best in people in the workplace. Nobody tells you about most of those practices when you join an organization, and once you are working away at a demanding job, it's easy to lose track of what you really need to be doing to succeed in your position—and to lead others to do the same. In this section of the course, then, we will learn the practices that are most important for organizational success within your enterprise—both as an employee and as a leader or potential leader.

Our study of organizational behavior will attempt to do two critical things. First, it will help us understand why people behave the way they do at work. Second, it will help us discover what leaders and professionals can and should do to bring out the very best in the people that work within their organizations. We will look at the critical concepts and strategies that we can all use to maximize the performance and job satisfaction of everyone involved in making an organization successful.

In short, understanding organizational behavior is really all about learning how to create "people power" in the workplace. We will look at the science of human behavior, and using those findings, we will develop tools to help put people in the best position to succeed. As we'll see, a thorough understanding

of organizational behavior can help all of us create competitive advantage with people—and that's a critical and vital skill for organizational success in the 21st century.

In these lectures, we will explore such topics as career success and survival, the critical nature of leadership, the importance of great interpersonal skills and emotional intelligence, and effective communication with coworkers and employees. In addition, we will learn how to create an organizational climate that maximizes human performance in the workplace, how to create and foster teamwork with the people around us, and how effective coaching and feedback can nurture great performance. Other topics include understanding power and influence at work, managing your boss, understanding and resolving conflict, and appreciating the ethical challenges associated with success. Finally, we will look at how to lead and facilitate the process of organizational change and how to develop ourselves to meet the changing demands of our jobs. Throughout this section of the course, the lectures will challenge your thinking, ask you to look in the mirror, and give you specific action assignments to ensure that you know not only what to do but how to do it.

In a nutshell, these lectures will better equip you to be successful in your job, deliver better results for your employer, and create a track record of performance that will lead to career success! ■

Achieving Results in Your Organization

Lecture 37

Human beings are social creatures, and human behavior within organizations tends to follow certain recognizable patterns. The field of organizational behavior was established to study those patterns and to develop practices for bringing out the best in people in the workplace. This lecture will introduce you to that field and give you an important tool for analyzing and improving your own workplace behaviors.

The Field of Organizational Behavior

- The study of organizational behavior attempts to do two critically important things: First, it helps us understand why people behave the way they do at work, specifically focusing on intentional behaviors that contribute to business success and business failure. Second, studying organizational behavior helps us discover what leaders and professionals can and should do to bring out the very best in the people that work in their organizations.

- In short, then, understanding organizational behavior is really about creating "people power." Organizational behavior can help a leader create competitive advantage with people—a vital skill for organizational success in the 21st century.

The Busyness Continuum

- In a study of 6,000 business professionals, the great majority said that the most important factor in career success was developing a strong track record of delivering results. But the minutiae that permeate our jobs on an everyday basis can distract us from that goal. We need to understand what all those distractions are doing to us if we're going to put our focus back where it belongs.

- Visualize a continuum measuring how busy you are on a typical day. From less to more busy, we have the following categories:
  - Not Busy—living a quiet life with a minimum of activity

- Busy—being actively and attentively engaged; living a life full of activity, responsibilities, and commitments

- Really Busy—being engaged in constant, challenging, and ongoing activity

- Too Busy—finding yourself overcommitted; being in a state of constantly having more things to do than can be realistically accomplished.

- If you're like most professionals in the 21st century, you probably find yourself in the Really Busy category. Although that's a challenging spot to be in, it's unfortunately just a fact of life in today's business world.

- But a growing percentage of working professionals regularly find themselves in the Too Busy category. In fact, it's not uncommon to conduct a management development program and find that more than 50% of the participants feel they're too busy.

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If you have a demanding job, it's very easy to lose track of what you really need to be doing to succeed in your position.

- When we're too busy, our ability to communicate breaks down, and our listening skills diminish. We tend to lose focus and attention to detail. Problems that need our attention are left unresolved, or they're simply ignored altogether. Busyness can damage our ability to focus our time and talent on doing the things that lead to getting desired results.

S.T.O.P. Being So Busy

- When things in the workplace become increasingly pressurized, fast-paced, and turbulent, it's only logical to respond by trying to do the same work that you've been doing quicker or to develop more sophisticated and complex solutions to the logistical challenges you face. But in fact, when things in the workplace get crazy, it is imperative that we slow down and exercise self-leadership and leadership of others with greater precision, passion, and persistence.

- An effective way to achieve this is through a model called S.T.O.P., which stands for Sit, Think, Organize, and Perform. S.T.O.P. is the process of slowing down and becoming more intentional and mindful in the way you approach your work and life. The process is very straightforward:
    - **S**it quietly, someplace where you won't be disturbed.

    - **T**hink about what you really need to accomplish, as opposed to everything else you're supposed to do that may be less important.

    - **O**rganize yourself to place top priority on the results that really matter.

    - **P**erform based on your priority system, checking your results to make sure that you are meeting your goals.

Strategic S.T.O.P.

- A strategic S.T.O.P. requires that you have a monthly, quarterly or semi-annual "strategic planning retreat" with yourself to think through and answer the following critically important questions: What specific results do I need to deliver in order to be successful?

What specific activities and practices do I need to engage in to deliver desired results? Am I currently investing my time at work on the activities that deliver the results we need? Your answers to these questions will help you create real focus around what you are being paid to deliver in your current position.

- Once you're established that focus, here are three more questions you need to answer if you want to deliver the results that you've identified: Are my working relationships where they need to be to deliver superior performance and results? Is there a talent or skill that I need to work on to improve my performance? Is there a problem or barrier that is getting in the way of my performance that I need to fix immediately?

- Finally, come up with a plan to measure your ongoing performance at work to ensure that you stay on track. Don't underestimate the importance of this last strategic S.T.O.P. component because it is imperative that all of us become proficient at self-leadership to make sure we are getting results. Establish and maintain a scoreboard for yourself to track the key performance metrics that are most important for your success.

- Once you've answered the strategic S.T.O.P. questions for yourself, it's time to sit down with your boss and share your plan. This will allow you to make sure that the two of you are on the same page as you seek your boss's input, create proper alignment, and open up critical channels of communication with him or her. Most bosses are really busy, and they will appreciate the fact that you are trying to help them focus on delivering better performance.

Daily S.T.O.P.

- In essence, a daily S.T.O.P. is just a more detailed, shorter-term version of the strategic S.T.O.P.—but paying attention to its details will pay big dividends. As with the strategic S.T.O.P., the first step is simply to sit. Start each day by slowing down, being still, and finding a quiet and isolated place where you will not be disturbed.

Research shows that sitting and relaxing in this fashion causes various pathways in the brain to open up, and doing this daily gives us better access to important stored information that we can use for handling each day's challenges.

- You need at least 15 minutes to refocus your thoughts from the urgent, pressing issues of the moment to the key activities of the day and the things you really need to get done. Wrap your thinking around these questions: What specific results am I being paid to deliver? What activities will get me there today?

- The third step, again, is to organize. It is imperative that you organize your thinking to develop a performance script for the day. Identify a realistic list of specific results and activities that you must accomplish on this day. Once you have the activities mapped out, realistically estimate the amount of time you'll need to complete each one.

- Next, determine who you will need to include in each activity. Make sure you pull key people into this thought process; doing so can make a real difference in the outcome. Once your activities are planned, you know roughly how long each one should take you, and you've figured out the key people you'll need to involve, determine what activities you can take off your list.

- Finally, prioritize the remaining items on your list and develop a written plan of attack. The product of this process is your performance script for the day. Now you're ready to move to the final step of the daily S.T.O.P. exercise: Perform.

- As your day unfolds and you implement your plan of attack, take five minutes halfway through the day to review your plan and make adjustments. At the end of the day, take another five minutes to do a brief review of what you did and didn't accomplish. Those five-minute assessments will be invaluable in helping you develop your plan for the next day.

Make Planning Routine

- Take the time on a regular basis to figure out exactly what your boss really needs and wants from you and how to use your time in the best way to produce those results. There are no magic bullets or secret elixirs for improving performance. The only real way to go about it is with careful thought, planning, and follow-through.

- But by spending just 25 minutes a day on those activities, you can achieve wonders. Keep in mind that 25 minutes out of a nine-hour workday in only 4.62% of your day.

- Research on high-performance leaders shows that when people use that small percentage of each day to S.T.O.P., they are rewarded with greater job satisfaction, improved working relationships, reduced stress levels, and significant improvements in both the quality and quantity of their performance. In fact, research has found that by investing less than 5% of your workday in the S.T.O.P. process, you can improve your performance by anywhere from 12% to more than 30%—a great return on your investment.

- The beauty of studying organizational behavior is that the lessons we learn can be applied in almost any organization or situation in which people need to work together. If you can learn to lead yourself and others to consistently achieve the results that your job requires, you'll be a highly valued part of your organization.

Suggested Reading

Lencioni, *The Advantage.*

Longenecker and Simonetti, *Getting Results*.

Questions to Consider

1. Why is understanding organizational behavior important for your career success?

2. What specific results are you being paid to deliver for your organization? Are you and your boss on the same page with regard to this question?

3. Have you identified the specific workplace behaviors and actions that are necessary for you to achieve the results expected of you?

4. Do you consistently use your time and talent to do the things that will deliver desired results for your organization?

The Value of Great Leadership

Lecture 38

Effective leadership is essential in any organization. It's a skill for which some people have natural talent, but it's also an ability that can be cultivated. Great leaders—from such wartime figures as General Dwight D. Eisenhower to such business innovators as David Packard—tend to use a very specific set of skills and practices to get great results from the people they work with. And once you understand those skills and practices, you can make yourself into an effective leader, too.

The Importance of Leadership

- The practice of leadership is becoming increasingly important in our ultra-competitive marketplace because effective leaders can dramatically impact a wide range of critically important organizational performance variables. Leadership can affect innovation, transformation, productivity, efficiency, employee turnover, workforce motivation, and job satisfaction.

- Good leaders tend to bring out the best in all of us, and they typically make good things happen. Meanwhile, poor and ineffective leaders tend to make our work lives problematic when things are already challenging enough. In fact, they can make it tough to get out of bed, come to work, keep a positive attitude, and actually get work done.

- Ideally, a leader is someone who has the talent and character to influence others in productive and positive ways—although we do not have to look too far into history or the newspapers to find plenty of leaders who used their talents for destructive and even evil purposes.

- Leadership is all about connecting with people and doing the things that followers need so that they can be successful. Remember, successfully delivering desired results is the key to career success and survival.

Two Components of Effective Leadership

- At its core, effective leadership is always based on the interaction of two critically important factors: competency and character.

- A leader is competent when he or she possesses the requisite skills and talents necessary to successfully help people achieve desired results in a given situation. Put simply, leaders know what they're doing.

- Leaders have character when they possess the moral and ethical underpinnings necessary to do the right thing and lead their people in a principled fashion. When leaders have character, it means that their people can count on them to do the right thing. A boss who lacks character and a strong moral compass can turn a work environment into a disturbing, distressing, and distrustful place.

- Taken together, competency and character create a leader's trustworthiness. When people trust their leader, good things happen. A leader's competency and character can have a powerful impact on the leader's followers, causing them to be motivated, supportive, and loyal to their boss and the organization.

- Conversely, when we find ourselves working for a leader we deem untrustworthy because of a lack of competency or character, our focus shifts from doing our job and getting results to finding ways to make up for our boss's shortcomings.

Six Schools of Leadership

- Six leadership schools of thought can make a real difference in your understanding of leadership. These schools provide us with some key leadership takeaways.

- The trait leadership school: This line of thinking holds that it is critically important for all of us to know our strengths and weaknesses as leaders. If we are serious about being successful as leaders, we need to develop the necessary talents, skills, and persona for any given position.

- The behavioral leadership school: This school professes that leaders can and must demonstrate a real concern for people. They need to balance their concern for the task of getting results with a genuine concern for their employees.

- The contingency or situational leadership school: In this theoretical camp, effective leaders are those who take into account the circumstances under which they are asked to lead, then develop an appropriate leadership style to meet the demands of that situation. Leaders must diagnose and clearly understand the dynamics of the group that they are being asked to lead and the circumstances under which they are being asked to operate.

- The transformational/charismatic leadership school: This school makes a compelling case that certain leaders can have a powerful and lasting impact on followers because of their passion and their charismatic personalities. Great leaders use their view of the future and their personalities in positive and powerful ways to affect their followers.

- The results-based leadership school: This school embraces the approach recommended by Stephen Covey, the author of *The Seven Habits of Highly Effective People*: Start with the end in mind. This growing leadership style works in reverse by first identifying the desired goals and outcomes that leaders must achieve for success, then cultivating the specific behaviors and practices that will enable them to move their followers in that direction.

- The psychological or emotional intelligence leadership school: This school cites a growing body of research that makes a strong case for a leader's emotional intelligence as vital to his or her success. As a leader, it is imperative that you know and understand how to work and connect with all kinds of people.

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Effective leaders make sure their team members know what's expected of them and how to achieve it.

Focusing on the Mission and Results

- A leadership study that engaged more than 500 managers in more than 100 focus groups identified several common attributes of great leaders.

- Great leaders realize that the first and most important job of any leader is to create focus and a clear sense of purpose for their followers.
  - Whether it's Abraham Lincoln's unrelenting focus on saving the Union or Henry Ford's goal to build an affordable car for the masses, great leaders create a vision that their followers know, understand, and can believe in.

  - During the Second World War, General Dwight D. Eisenhower was renowned for his ability to manage huge projects, such as the D-Day landings. He had an uncanny talent for effectively delegating work and letting each person know exactly what he or she needed to do for the effort to be a success.

- Most study participants said that great leaders have the ability to balance concern for the task and getting things done with great concern for their people. John Chambers, the longtime CEO of Cisco Systems, is famous for his emotional intelligence and his passion for connecting with everyone in his organization. His organization makes it a priority to hire and develop leaders who do the same, because such leaders understand that motivated people and purposeful social networks are key to success.

- Great leaders are also recognized for their prowess in knowing how to get others to come together and work as a team. Charles Coffin, the founder and CEO of General Electric, began his career in the shoe business. But because of his uncanny ability to get scientists to work together and cooperate in research laboratories, he is credited with creating one of the most enduring and widely emulated high-tech enterprises in the world.

Preparing Followers

- The best leaders frequently receive great acclaim for their willingness to properly equip and prepare their people for success. These leaders take the time to plan and effectively communicate strategies to their people, both to create a sense of ownership and so that everyone knows what is coming.

- The automotive genius Henry Ford was a pioneer in training and properly equipping his workforces to they build cars quickly and cheaply. Moreover, he believed in trying to find ways to help people do their work without difficulty, which was unheard of back in the late 19th and early 20th centuries.

- One of the more interesting attributes of great leaders is the fact that they have the habit of making it easier for people to get their work done. They do this through rapid problem solving, ongoing process improvement, effective and timely decision making, and the ability to quickly remove performance barriers.

Integrity and Transparency

- In the leadership study, great leaders were consistently described as having character and integrity. Study respondents said that the very best leaders are trustworthy in that they demonstrate principled behavior, even when no one is watching, and they show that their word is always reliable and dependable.

- The cofounder of Hewlett-Packard, David Packard, was recognized as one of the top CEOs of all time—not just because of his business prowess, but because of his passionate belief in the dignity of people and the high ethical standards he set for himself and for the members of his entire organization.

- We all want to follow and work for people that we can respect, whether it's the CEO of our company or our immediate supervisor.

The Work-Life Balance, Passion, and Mojo

- One of the leadership study's more provocative findings was that great leaders were credited with not wasting time and with operating in a fashion that helped them create and maintain a work-life balance for themselves. Importantly, they did the same for their employees, in spite of the fact that they were in exceptionally demanding positions.

- The very best leaders work hard to maintain this "tightrope" balance, and they encourage the people who work for them to do the same. This balance is critically important for long-term success in business and in life.

- Great leaders demonstrate passion, energy, excitement, enthusiasm, gusto, and "mojo" for what they are doing. They go about their business in a highly motivated fashion, with vitality that creates momentum and drive for the people who follow them.

- When people talk about such leaders as Sam Walton, Bill Gates, or Michael Dell, they inevitably describe them as truly excited and passionate about their mission, their work, and the lives they are changing.

Suggested Reading

Drucker, *Managing for Results*.

Ulrich, Zenger, and Smallwood, *Results-Based Leadership*.

Questions to Consider

1. If you are a leader at work, can you explain the specific reasons that people will want to follow you?

2. If you are currently in a leadership position, do you possess the specific skills and competencies necessary to bring out the best in others? If not, what are you doing to improve?

3. Do you lead by example and demonstrate character and principled behavior in everything you do? If not, why not, and what are the costs of not doing so?

4. If you are in a leadership position, are you doing the things that enable your people to perform in an optimal fashion?

Emotional Intelligence in the Workplace

Lecture 39

Workplace relationships have the potential to create real drama, problems, and even pain because some people don't know or don't care to think about how to work effectively with others. Such disruptions can make your professional goals extremely difficult to reach. To counter that, this lecture will examine the importance of having 360-degree working relationships and what these relationships look like. We'll also discuss the importance of developing your emotional intelligence, which can have a real impact on your ability to work well with others.

The Importance of Good Relationships

- To be successful in modern organizations, we need the help of other people. Having great working relationships is a critical gateway to getting the help we need. The statement, "No man or woman is an island" is especially true at work.

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When we get along with people at work, stress levels go down, and there is far less drama in the workplace.

- When we get along with the people at work, there is almost always a better flow of information and stronger communications. We know that people are more willing to help one another, share knowledge and experience to promote learning, and work together to solve problems and achieve goals.

- In addition, the people we work with can have a significant impact on our willingness to come to work, our attitudes when we get there, and our willingness to stay with our current employer. Great working relationships can be a tremendous source of motivation, encouragement, and satisfaction.

Organizational Networking

- Organizations today are complex places, and the greater the complexity, the more difficult it can be to get things done. But you can handle that complexity by building a network of human connections and great relationships within it.

- The organizational chart of your own enterprise can appear daunting. But it looks a lot less so if you can say, "Oh, I know Cindy over in IT," or "Shannon in HR can help us," or "I bet that Larry in Operations will know."

- It is critically important to identify the key people in your organization with whom you need to develop mutually beneficial working relationships and to take proactive steps to foster and nurture these human connections. This requires great people skills, proper focus, and time.

Effective 360-Degree Working Relationships

- It is a career imperative that we forge effective *360-degree working relationships* with people above us, our peers and coworkers, and if you're in a leadership position, the people that report to you. An *effective* working relationship is one that fosters ongoing support and positive interactions that facilitate the ability to get results in a healthy, sustainable way. The *360-degree* component means that you need effective relationships with everyone you work with.

- In business publications, it is not uncommon to read provocative accounts of boardroom brawls, bitter disputes among research scientists, or workgroups at war. Organizations often struggle because of the inability of people to come together, work together, and leverage their collective talents. Conversely, when people make working relationships a real priority and work hard to develop their people skills, great things can happen.

- Research for the book *Getting Results* found some reoccurring themes of great working relationships that are important to keep in mind.
    - First, there is the *relationship* part of the equation. Effective working relationships are based on each party demonstrating mutual respect for the other, engaging in acts of common courtesy, behaving appropriately, and showing trust.

    - Second, there is the *working* part of the equation. Effective working relationships are based on mutually understood performance expectations and needs, as well as a shared sense of responsibility and ownership for the work to be done.

Analyzing Your Work Relationships

- Now that you know what good working relationship look like, how do you go about developing them with the people with whom you need to work to be successful? The following exercise can get you thinking about who those people are.

- On a sheet of paper, list all the people that you count on to get your work done. Then, prioritize your list in order of importance and the impact that each of these people has on your ability to deliver. Next, candidly rate the quality of each of these working relationships using the following categories:
    - **Non-working relationships** are broken connections. They're relationships in which we really struggle to interact effectively and work with people.

- **Strained working relationships** are relationships in which we can work with people but don't enjoy doing so. These often involve recurring tension and unpleasant undercurrents.

- **Positive working relationships** involve folks we get along with quite nicely. These relationships are productive, pleasant, and cooperative.

- **Great working relationships** are strong connections where we know the people we're working with quite well, and they know us. We know what we are trying to get done, and we have a shared sense of purpose and responsibility.

- In the first two categories, your working relationships are not where they need to be. Whether you are willing to admit it or not, these relationships hurt and hinder your ability to deliver desired results and enjoy work. In a nutshell, these are performance-damaging relationships that need some real attention.

- If any relationship is not working, you should respond to the situation as you would any other performance problem. You need to analyze the situation, identify the root cause of the problem, select appropriate action, and implement the necessary changes.

- If you have performance-damaging relationships that are holding you back, it's your responsibility to take action. Don't assume that time will heal or fix real problems that prevent people from working together.

- Occasionally, people who need each other to get things done simply don't like each other. Or they get off to a bad start that is the beginning of something that only gets uglier. More often, though, strained working relationships degenerate over disagreements, problems, or frustrations concerning issues of substance that never get discussed or appropriately resolved.

- The second two categories—positive and great working relationships—can be classified as performance-enhancing relationships. These relationships need to be protected and nurtured by continuing to do the things that made the relationship work in the first place.

- Certainly, if we neglect the relationships, stop communicating, or cease demonstrating concern and empathy for the people in our performance-enhancing relationships, they can degenerate, just as a neglected marriage or dating relationship might.

Developing Emotional Intelligence

- The primary way you can help heal broken working relationships is through developing emotional intelligence. Put simply, emotional intelligence is the ability to recognize and manage your own emotions and those of people around you.

- In 1998, Harvard psychologist Daniel Goleman wrote a breakthrough book entitled *Working with Emotional Intelligence*. It had always been assumed that if people had great cognitive intelligence or a high IQ, then they would be successful in their careers. But Dr. Goleman's research found that a person's emotional intelligence, or EQ, actually plays a more crucial role than IQ in terms of long-term career success.

- Some people seem to have greater natural ability to empathize than others. But there are four particularly significant aspects of emotional intelligence that you can develop: self-awareness, self-management, social awareness, and relationship management skills.

Dimension 1: Self-Awareness

- People with high self-awareness recognize and understand how their emotions affect their behavior and thinking. They also have an accurate assessment of their strengths and weaknesses, which enhances their self-confidence. And they understand that their emotions and behavior can have a powerful impact on the people around them.

- People with high self-awareness are good at not letting their emotions have a negative impact on their relationships with other people, and they are open to receiving feedback from others.

- In contrast, people who lack self-awareness often can't control their emotions or make no effort to control them. It is important to note that highly effective people typically have great self-awareness and find ways to control their emotions.

Dimension 2: Self-Management

- The second dimension of emotional intelligence is self-management, which allows highly effective people to stay focused in order to achieve a desired goal. People with this dimension demonstrate self-control, transparency and candor, and optimism and persistence in pursuing goals.

- People who have strong self-management capabilities tend to be self-motivated and set challenging goals for themselves and others. They are willing to work hard and demonstrate flexibility in adapting to changing situations or dealing with problems.

- In a nutshell, people high on this dimension know what they want and manage themselves in a fashion that increases the likelihood of success.

Dimension 3: Social Awareness

- The next two dimensions of emotional intelligence shift from understanding and managing oneself to focusing on other people. Social awareness is the capacity to sense and understand how others feel, want, and need and to take an active interest in the concerns of other people in a given situation.

- People with great social awareness are good at reading and tuning in to the situations in which they find themselves. They seek to understand the organizational context to help them make sense of the things going on around them.

- This social empathy helps people demonstrate sensitivity toward others, which in turn, allows them to recognize other people's accomplishments and offer advice and feedback in ways that don't offend people.

Dimension 4: Relationship Management Skills

- The final dimension of emotional intelligence is possessing strong relationship management skills. These skills allow an individual to influence the emotional tone of a group, to articulate a direction or vision, and to influence the behavior of other people in positive and sustainable ways.

- People who are strong in this area are good at getting people to unite around the things that are important and at directing them to where the group needs to go to be successful. They typically lead by example and possess the ability to deal with difficult people in confident and straightforward ways.

- People who have effective relationship management skills are willing to put energy into developing others, they're quick to resolve conflicts and disagreements, they're team oriented, and they look for ways to inspire others and initiate needed change.

- It is critically important for all of us to invest time and energy in our working relationships and to look for ways to maintain, motivate, and encourage others to experience the benefits of working together.

Suggested Reading

Goleman, Boyatzis, and McKee, *Primal Leadership*.

Longenecker and Fink, "Fixing Management's Fatal Flaws."

Questions to Consider

1. If we asked your coworkers to describe what is like to work with you, what would they have to say? Would they say you are easy to work with?

2. Have you taken the time to clearly identify the people that you absolutely, positively need to have great working relationships with in order to do your job effectively?

3. Do you invest the time and energy necessary to build and maintain quality working relationships with the people around you?

4. Do you have a plan to improve your relationships by developing your "people skills" and becoming more emotionally intelligent?

The Art of Effective Communications

Lecture 40

Language and communication techniques are vital, but the foundation of effective communications is wanting to be understood by the other party—and desiring to understand what the other party is trying to communicate to you. Effective communication is all about the motivation behind the presentation of information. If we really need to get an idea across to someone, we can always find a way to make ourselves understood. In this lecture, we'll look at why effective communication practices are so important and how to implement them in your organization.

Communication Problems

- In organizations, leaders frequently lack the motivation to learn effective communication methods, either because they don't understand their importance or because they overestimate their own communication skills. And people within the organization who are strongly motivated to communicate are often given the message that what they have to say isn't valued. As a result, they sometimes lose their motivation to communicate and, ultimately, to work altogether.

- At the heart of the communication problems within many organizations is a misunderstanding of the nature of effective communications. Communicating, especially in the workplace, is not simply about sharing information.

- Well-known Chicago journalist Sydney Harris captured the essence of this important point: "The two words information and communication are often used interchangeably, but they signify quite different things. Information is giving out; communication is getting through."

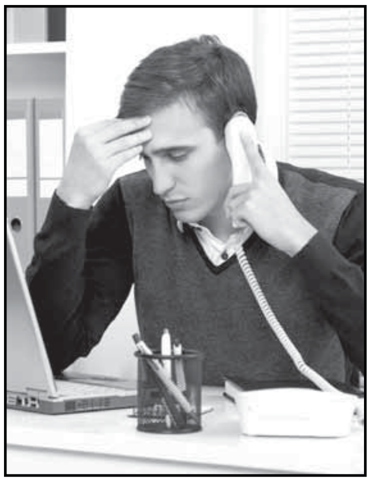
Getting Through

- People in organizations typically have three burning communication needs:
    - First, we all need the information that is necessary to do our work efficiently and effectively. This can include knowing and understanding such information as current job assignments and responsibilities, instructions and updates on projects, performance feedback, tactical plans, or perhaps something as simple as the deadline for a report.

    - Second, we all need to be informed about the things going on around us that affect our future. This includes such information as current operating performance, new and future market opportunities, personnel changes, and new technologies.

    - Third, we need the means and opportunities to make our voices heard when we want to raise a concern, get a question answered, identify a business opportunity, share a new idea, make a suggestion, or offer input on an important issue.

- Knowing that we have a voice and that others are willing to listen has a powerful impact on our job satisfaction, motivation, and commitment to an organization. But leaving any of these three basic communication needs unmet causes people to divert their focus from getting things done. Instead, they turn to seeking out the information they want and need—or they spend time trying to find someone who will listen to their concerns.



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Ironically, the sheer number of communication technologies available today can make it more difficult to communicate effectively.

- Why does this happen? Consider these possible factors:
    - First, organizations often have a great deal of information swirling around inside them that is not properly packaged to satisfy people's needs.

    - Second, in today's environment, we are all wrestling with an unprecedented volume of data and other information. Ironically, this problem is caused by all of our new communication technologies, such as e-mail, instant messaging, text messages, and social media. We can easily find ourselves operating on the edge of information overload.

    - Third, our workplaces are much more diverse than in the past, which adds another degree of complexity to the communication process that we all need to take into account. Such factors as generational differences, culture, and educational and socioeconomic backgrounds can affect our ability to communicate effectively with one another.

Tools for Fixing Broken Communications

- People in any organization want an overall communication process that is ongoing, organized, systematic, and designed to meet their needs, rather than something that is pell-mell, ad hoc, or crisis driven.

- The leader of an organization doesn't need to be a communication genius to establish a highly effective communication system. Much of what leaders need to know about establishing good communications within their organization is readily available to them, if they're willing to ask their employees for input and suggestions and listen attentively to the answers.

- Do you and your coworkers and employees have a systematic approach to ensuring that people have the right information, at the right time, at the right place, and in the right form to be able to get their work done? If not, it may be time to look at the types of information that the people in your organization need to be more effective, then build out the practices that can help meet these needs.

- Valuable tools address the communication needs we've identified. The first need is for real communications that put people in a situation where they can successfully perform their jobs. Here are some communication practices you can use to help meet that need:
    - Conduct regular one-on-one performance planning sessions to clarify performance expectations
    - Provide written instructions, policies, and work procedures that people can access easily
    - Implement ongoing one-on-one feedback and coaching meetings
    - Develop organizational cultures that encourage regular interactions with superiors and coworkers
    - Use team meetings to share new information and performance feedback
    - Provide information to people on an ongoing and systematic basis about the status of current projects and important programs
    - Employ electronic and web-based information portals to provide people with current performance data and information.
- The second need we discussed was that of being in the loop—the importance of giving people in your organization a clear understanding of what is going on around them. Communications of this sort are designed to give people the context to better understand the "big picture" of the enterprise and where they fit within it. Here are some tools you can use for that purpose:
    - Run effective and time-sensitive staff meetings
    - Conduct town hall meetings where leaders and workers share important information about what is going on in the organization
    - Build web pages for internal use that provide employees with information they want

- Use organization-wide voicemail blasts to communicate about big events, breakthroughs, and successes

- Employ teleconferences and web-based informational meetings to keep people informed without time-consuming travel

- Create electronic and whiteboard information postings to provide up-to-date information about important issues

- Send out informational update e-mail blasts

- Produce informational videos that deliver accurate information in a dynamic fashion.

- Third, we discussed the importance of providing employees with a voice and an opportunity to express their concerns, offer input, and have their questions answered. You can make that possible with a number of proven practices, including the following:
    - Get leaders to engage and empower workers to take greater control over their work through participative leadership

    - Hold brainstorming meetings and input sessions with small groups or on a one-on-one basis with leaders and employees

    - Use team-based problem solving to solicit employees' ideas about how to deal with organizational problems and performance

    - Implement continuous improvement processes

    - Make use of employee surveys, suggestion systems, and hotlines for gathering additional employee input

    - Conduct regular, effective staff meetings where employees can express concerns, share ideas, and voice their opinions with their immediate supervisors.

Lessons for Effective Communication

- Effective communication practices are essential for a well-functioning organization. But it's important to recognize that they don't necessarily ensure success unless the people who are doing the communicating are viewed as trusted sources of information. Leaders need to be able to deliver and receive information in a highly effective fashion. That's why leaders and employees need to engage in all communication-related practices with both character and competency.

- Communicating effectively doesn't come naturally to everyone. Although it's easy to criticize the communication failings of others, it can be difficult to see the flaws in our own communication skills. Below are six lessons that can improve your effectiveness as a communicator:
    - Take every communications opportunity seriously. Know that each and every opportunity to communicate in an organizational setting is either a problem-solving experience or a problem-creating experience, based on our actions.

    - Your credibility is key. Never underestimate the importance of the credibility of the communicator. If you give other people inconsistent information or make them a promise that you fail to keep, people will learn quickly that your words aren't worth their time and attention.

    - Be self-aware. Self-awareness encourages us to know our strengths and weaknesses as communicators and to understand how our emotions can affect our exchanges with others.

    - Be socially aware and empathetic. It's important to develop your social awareness and empathy in order to tailor your message to meet the needs of your audience.

    - Exercise self-management. Self-management can play a critical role in helping you improve as a communicator. You need to have the ability to monitor your own speaking and listening practices and take corrective action when you discover them lacking.

    - Listen. The cornerstone of every relationship is our ability to communicate, and listening is an essential part of it. That means you need to develop and refine your listening skills with everyone you work with, from your boss, to your colleagues, to your employees, to the person from IT who fixes your computer. If you can't listen to what's on people's minds, you won't be able to help them get their work done, and you probably won't be able to get their help in completing yours.

- Remember, effective communication is about speaking so that other people are willing to listen, and listening so that other people will be willing to speak. Whether you're a boss or an entry-level employee, make sure that your communications with the people you work with don't flow only in one direction. Express yourself clearly, but always be willing to listen and encourage an open exchange of ideas.

Suggested Reading

Carnegie, *How to Win Friends and Influence People*.

Hauden, *The Art of Engagement*.

Questions to Consider

1. In your workplace, what are the problems created by ineffective communications?

2. Do you know exactly what information you and your coworkers need to be effective in your jobs?

3. Are you effective in keeping people informed about what is going on in the workplace and why it's important?

4. Are you careful to listen to what people are sharing with you, and do you have a practice in place to solicit ongoing feedback from your employees about things you need to know and understand to be effective?

The Motivation-Performance Connection

Lecture 41

Motivation and performance improvement are two of the most researched, popular, and written-about subjects in the domain of organizational behavior. Every company needs to operate at peak efficiency in order to survive and thrive. There's simply no room for unmotivated employees or subpar performance, and any company that accepts poor or even mediocre employee performance is unlikely to be around for long. If you hope to lead people in the business world, it's critically important that you have a thorough understanding of how to create a workplace environment that brings out the best in everyone.

The Importance of Motivation

- Company leaders are well served when they focus serious attention on creating a productive workplace that keeps their employees motivated. In fact, there's widespread recognition among managers that employee motivation is a critically important issue. Several years ago, a survey of a large sample of U.S. managers on that very subject found that:
    - Eighty-five percent of managers believed that an employee's level of motivation has a significant impact on his or her performance
    - Seventy-nine percent of managers believed that motivating employees is one of the most important functions they perform as leaders
    - Ninety-four percent of managers believed workforce motivation was truly important to the success of the overall operation
    - Eighty-two percent of managers believed that their behavior had a significant impact on their employees' level of motivation.

    - Two-thirds of managers believed that it is getting tougher to motivate their employees.

- These findings suggest that although managers know they need to motivate their workforces, a significant percentage of leaders are struggling to figure out how to do it.

- It helps to have a straightforward definition of the word *motivation*: "the level of inner drive and energy a person is willing to expend on a given activity to satisfy an unmet need." An important note is that our inner drive can be greatly affected and shaped by the things going on around us and the context in which we operate.

- It's common to think of motivation as a factor that can be influenced in isolation. Give someone the right incentive, the thinking goes, and he or she will be motivated. It's also common to think of motivation as governing performance. On a gut level, we all tend to believe that if people are motivated, they will work harder, and that when people work harder, they perform better and deliver better results. All those beliefs are accurate to a point, but they oversimplify what is actually a much more complicated dynamic.

Key Motivational Practices

- Several years ago, a large-scale study of 60 high-performance organizations revealed a pattern of key practices.

- First, each of the companies in the study took great care to make sure that its employees had the requisite talent to compete successfully. Talent may include innate ability, but in the workplace, a talented employee is someone who brings valuable knowledge and skill to a job. That's important, because knowledge and skill can be cultivated. The organizations focused on making sure that their employees were well suited to their jobs, and they made systematic training and development a large part of their corporate cultures.

- Second, the companies focused on motivating their employees in a methodical and holistic way. They got their employees to understand their missions and the needs of their customers, so the employees would see the importance of performing to a high standard. They established clear goals and performance standards for everyone, so the employees understood what was expected of them. These companies designed each job in a fashion that fostered employee decision making, participation, and empowerment to ensure that all employees felt respected, valued, and invested in the organization's success.

- Finally, these organizations provided appropriate support for their workforces. It was readily apparent that they worked hard to keep their employees in the communication loop. They also set up systems to remove performance barriers quickly and to solve problems that could derail performance. In a nutshell, these companies didn't just focus on employee motivation; they created organizational climates and cultures that brought out the best in people.

The Performance Equation

- The approach taken by these successful organizations was so consistent that it could be expressed mathematically. That led something that called the *performance equation*, which is: performance = f(talent × motivation × support).

- What that means is that performance is a function or byproduct of the interaction of talent, motivation, and support. All three parts of the performance equation must be in place to avoid demotivating people who are trying to get things done at work.

- What if an employee has talent and is highly motivated but doesn't receive the support she needs? In a fairly short period of time, she will become frustrated and demotivated because she doesn't have the information and tools required to perform her job.

- What if an employee the talent to do the job but is highly motivated and has solid support? This employee might work hard, even enthusiastically. But while doing so, he might damage a machine, erase a database, offer clients bad advice, or destroy a customer relationship, simply because he is not sure what to do.

- What if an employee has the appropriate level of talent and the support she needs to be effective but is not motivated to work and do a good job? Once more, performance will suffer. Intensive coaching and feedback are probably in order. But the company should also consider whether its work environment is really as supportive as it seems; not every employee is motivated by the same things,

Strategies for Workplace Motivation

- What can you do to create a more motivating, high-performance workplace? Consider the following strategies:
    - Start by clarifying and communicating your mission and what you stand for. If you really want to motivate people, help them understand the bigger picture of what you are trying to accomplish. Employees need to understand the "why" behind the "what" that they are asked to do.

    - Make getting to know your employees a priority. Understanding their strengths and weaknesses, their wants and needs, and their personalities and attitudes can be a real help in developing tailor-made motivational strategies that bring out the best in each person.

    - Clarify performance expectations for everyone. Nearly all current theories and models of motivation make a strong case for clarifying focus and giving people a sense of achievement and recognition. You need to create focus by helping employees identify the goals and activities that are most important for their success and that of your enterprise.

- Properly equip people with the support they need for success. If you want a high-performance workforce, remember that a starting point is providing your employees with the fundamentals necessary for success. When employees don't have the things they need to compete, you are automatically building in workplace frustration and anger and creating problems that distract people from delivering results.

- Empower employees to make decisions and share ownership over what you are trying to accomplish and how you are trying to do it. It's well known that when people own something, they treat it much better than if it belongs to someone else. You would be well served to give your employees a sense of ownership in your organization's plans by engaging them in planning, organizing, and decision making right out of the gate.

- Promote teamwork and make work more interesting and fun. From the start, build a solid leadership team around you with a shared vision, then look for ways to promote cooperation and teamwork throughout your organization. In doing so, you not only create a climate for effective motivation, but you also increase the support component of the performance equation.

- Develop the link between performance and outcomes. Organizations that do a great job of clarifying goals and expectations have the built-in benefit of a solid basis for rewarding good performance and addressing performance deficiencies.


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One of the hallmarks of high-performance organizations is that leaders and coworkers promote and encourage teamwork and cooperation.

- Provide ongoing and balanced performance feedback and coaching to everyone. Once you've established what people will be held accountable for, it is critically important that you and your fellow leaders make coaching a big part of your operation. Feedback is a powerful motivator, and praise can reinforce desired behaviors. At the same time, when people are not performing well, they need to be told so in a constructive way, with a game plan to help them get better.

- Be fair, forthright, and ethical in everything that you do. As you strive to improve the performance of your operation, work hard to ensure that fairness and transparency are cornerstones of your approach. People want to see fairness and equity applied to every part of your operation, including workload, distribution of resources, enforcement of workplace policies and rules, and of course, the rewards that you distribute.

- A final piece of advice: Go to your computer, pick a search engine, and type in "Best places to work in America." Spend some time looking at these great and productive places to work, and use them to develop your vision for where you want to take your own organization. You'll find a wealth of creative and innovative practices to help get you there. Keep the performance equation in mind as you make plans for your organization and as you tackle the performance problems that inevitably crop up along the way.

Suggested Reading

Longenecker, Dwyer, and Stansfield, "The Human Side of Manufacturing Improvement."

Nelson, *1001 Ways to Reward Employees*.

Questions to Consider

1. In your opinion, what are the things that truly motivate people to do their best work?

2. Conversely, what are the specific things that demotivate people at work?

3. What are the specific factors that affect a person's potential for achieving superior performance?

4. What needs to happen at your place of employment to create a more productive workplace?

Winning with Teamwork

Lecture 42

It's a premise of many economic theories that people seek to maximize their own interests in any given situation, and that may well be true. Unfortunately, though, people often fail to recognize that they can serve their own interests best by cooperating with one another. Teamwork and cooperation are absolutely essential in just about any work situation, with rare exceptions. This lecture will examine the power of teamwork and cooperation in an organization—and how you can foster them in your own workplace.

Cooperation and Teamwork

- The word *cooperation* has been defined as "a willingness to work or act together for a common purpose or benefit." Notice two critical elements in that definition: willingness and common purpose. When people cooperate with one another, they demonstrate not only an understanding that they share the same goal but a willingness to work together to get there.

- The word *teamwork*, which dates back to the 1820s, is sometimes used interchangeably with *cooperation*, but it's actually a bit different. It has been defined as "a cooperative and coordinated effort on the part of people working together with a unifying cause or goal."

- To have teamwork, you must have cooperation. But the definition makes it clear that the group's activity is coordinated and that the group members are unified by their common goal. Teamwork takes cooperation up a notch; instead of just helping each other out randomly or when needed, people who are engaged in teamwork work together in a coordinated fashion and help each other on an ongoing basis to accomplish a goal that binds their interests together.

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Like the pieces of a chess set, an effective team has individuals whose skills complement each other's.

- The term *teamwork*, of course, is based on *team*, which just might be one of the most overused words in organizational America. We frequently refer to groups of people in our workplaces as teams, using such phrases as "our executive team," "our office team," "we've got a strong sales team," or "our research team is very productive." But simply calling a group of people a team doesn't make them one.

- A team is a group of individuals with complementary skills and roles who are committed to a common purpose and are accountable to one another. The word dates back to the 9th century, when the English word *teme*, meaning "set of draft beasts," was conjugated with the Dutch word *toom*, meaning "bridle" or "reins." A team is a group of people whose efforts and energies are properly focused and directed and who hold one another responsible for their individual efforts as they pursue a collective goal or outcome. Note that the word *team* also implies leadership; someone must focus, or bridle, the team to direct it toward its objective.

Building Teamwork in Difficult Circumstances

- When a work unit is made up of individuals who have strong working relationships with the people they need in order to deliver results, cooperation and teamwork become part of the organization's culture. Moreover, in such an environment, unwanted employee turnover is lower, commitment to fellow workers is greater, productivity is higher, and overall results are better.

- The fact remains, however, that it can be extremely hard to get people with conflicting interests to overlook their differences and work together toward a shared goal. But this has challenge been accomplished—and under the most trying circumstances. There's no better example than that of the 16th president of the United States, Abraham Lincoln.

- In her remarkable book, *A Team of Rivals*, historian Doris Kearns Goodwin provides us with an amazing picture of how Lincoln and his chief political adversaries came together to become an effective leadership team that would later be recognized for saving the Union during the American Civil War.

- On May 18, 1860, four rivals—New York senator William H. Seward, former Ohio senator and governor Salmon P. Chase, former Missouri congressman Edward Bates, and Lincoln—waited for the results of the Republican National Convention. This convention would determine who would represent the party in the upcoming presidential election.

- When Lincoln received the Republican nomination, his three rivals were distressed, dismayed, and angry because each of them had vigorously and ambitiously sought the presidency. But the new president, from very humble beginnings himself, had an uncanny knack for bringing people together and getting them to see his vision of the future. Perhaps the best illustration of his leadership skills was his critical and unprecedented decision, after winning the presidency, to make his three eminent political rivals part of his cabinet.

- Seward became the secretary of state; Bates, the attorney general; and Chase, the secretary of the treasury. To complete his selections, Lincoln offered the three remaining cabinet seats to former Democrats—that is, people of the party that opposed his election. These men were powerful competitors to Lincoln, and some even initially displayed open disdain for their new boss. Yet in fairly short order, Lincoln's skill as an emotionally intelligent leader would win their respect.

- Goodwin's account of Lincoln's presidency provides us with an outstanding case study in the skills leaders need to forge a group of individuals into an effective team. Lincoln possessed the ability to see the bigger picture and help others share that vision. He had the capacity to focus on both the plan and the desired outcome and the persistence to press onward, even in the face of disagreements, setbacks, and personal tragedies, drawing upon his cabinet members for guidance at every turn.

- Lincoln had the ability to form friendships and great working relationships with the men who had previously disliked and opposed him. He took responsibility for failures, shared credit when things went well, and was quick to learn from his mistakes. Finally, Lincoln had the ability to deal with strong egos with decency and morality, and he communicated with compassion, honesty, humor, and empathy for his listeners. By doing these things, Lincoln was able to tap into and leverage the manifold talents, networks, political savvy, and prodigious intellects of his team of rivals.

Critical Gateways to Cooperation and Teamwork

- A set of practices called the critical gateways to cooperation and teamwork can help you enhance these areas in your organization. These practices don't cost much money, but they require patient and persistent leadership.

- First, if you are serious about increasing workplace cooperation and teamwork to achieve better performance, it is imperative that you lead by example. You must demonstrate the behaviors that will help

you become known as a team player. Keep in mind that if you're not a team player yourself, it will be exceptionally difficult for you to build an effective team.

- Second, clarify your mission. The quickest way to get a group of people to pull together is to develop consensus around your overarching vision, your mission, and key goals that are necessary for success. For example, President Lincoln used the clearly defined mission of saving the Union as a rallying cry to help his people stay focused on the big picture.

- Next, it's critically important that people understand their roles and what they need to do to make the workgroup successful. If you are a football devotee, you know that successful plays depend on every person performing his job correctly and knowing everyone else's job, as well.

- Critical behaviors and team-based norms are also essential for a workgroup to become a fully functional team. We should expect people to cooperate as a minimum requirement to work in any organization. But once people cooperate, we can build on their cooperative spirit. In Lincoln's cabinet, it was acceptable to disagree or to offer a different point of view. It was not acceptable to lose your temper or disrespect others.

- Another element of building an effective team is increasing the level of workplace participation and empowerment with the people in your workgroup. This helps people begin to take ownership over the things that are going on in an operation. As ownership of activities increases, so do teamwork and commitment to both what you're trying to do and how you're trying to do it.

- Savvy leaders also take advantage of team-building activities. There are many models for team development. You can foster team thinking through such events as off-site team-building retreats, where team members learn how to communicate more effectively with one another and develop action plans for performance improvement.

Another option is team-based training, where every member of the team is exposed to the same concepts and curriculum, which gives people common knowledge and a common language.

- Finally, it is important to implement team-based performance measurement, feedback, and reward systems. When the performance of a workgroup or team is measured and this information is fed back to the group on an ongoing basis, the process not only unites individuals but improves group cohesiveness and performance.
    - With regard to rewards, make a point of rewarding teams rather than just the individuals on the teams. A substantial body of research makes it very clear that team-based rewards can go a long way toward forging stronger levels of commitment, cooperation, and teamwork.

    - Further, if your organization measures team performance, it becomes easy and natural to celebrate team success—and celebrating team success is a surefire way to get people more excited about working together.

Suggested Reading

Goodwin, *Team of Rivals*.

Lencioni, *The Five Dysfunctions of a Team*.

Questions to Consider

1. Think of a time in your life when you felt as if you were part of a team that was getting great results. What was it that made this team so effective, and what are the lessons you learned from this experience?

2. Conversely, think of a time in your life when you were part of a group that never became a team and that struggled with performance. What was it that made this group so ineffective, and what are the lessons from this experience?

3. What specific things do you believe need to happen to improve the level of teamwork and cooperation among the people you work with?

4. Are you viewed as a team player by the people you work with? If not, what are the costs associated with not working well in a team environment?

Coaching—From Gridiron to Boardroom

Lecture 43

When leaders in any organization take coaching seriously, good results inevitably follow. Coaching can help people get and stay focused, learn and develop more quickly, and increase their level of effort. But it's important to keep in mind that not all coaching is good coaching—certain practices can be counterproductive if they alienate or discourage employees. This lecture will make a case for the importance of good coaching, provide examples of good coaching, and discuss the reasons that tailor-made coaching in particular works.

Pat's Problem

- To understand the importance of coaching, let's look at a case study with a manager named Pat who was confronted with a significant performance challenge. Pat's boss had warned him that performance goals for the next year were being cranked up—with no additional resources to help.

- Pat knew that hitting aggressive goals was going to be tough, and he felt overwhelmed. He had already used a computer upgrade and a process improvement to get better performance from his employees during the previous two years.

- After doing some research, Pat concluded that performance improvement could come from coaching. When Pat looked at his department's roster with a critical eye and saw that a number of people needed to step up their performance, he realized he needed to make developing his staff a priority.

Effective Coaching

- Research shows that Pat was on to something: A survey of U.S. business leaders revealed that they overwhelmingly realize the importance of coaching. Eighty-two percent of the sample stated that effective coaching was critical to their success. An even larger

portion of the sample, fully 93% of the participants, believed that employees wanted and needed coaching. Furthermore, 74% asserted that most employees do not get enough feedback and coaching.

- The business leaders demonstrated some sensitivity to the demands of good coaching: 68% of them believed that it was critically important to know their employees, and 78% believed that it was extremely important to understand an employee's ability and motivation.

- But the most telling result of the survey was the following: 80% of the business leaders in the sample believed that their coaching skills needed improvement, and a full 66% stated that they struggled to make the time for coaching.

Pat's Solution

- Let's walk through the coaching process that Pat used to improve the performance of his workgroup. To start with, Pat did a couple of online assessments, read a series of coaching articles, and went to a one-day coaching seminar. He also signed up for once-a-week coaching sessions with a consultant. Pat was smart enough to realize that he needed ongoing feedback and accountability to help change his own behavior.

- Pat identified specific behaviors that he needed to model for his team to let his employees know that he was serious about change. He realized that he needed to work on his punctuality, keep his desk a little more organized, and follow up on verbal commitments. He also needed to run better meetings.

- Next, Pat clearly defined *winning* for his team. Once his company's goals for the upcoming year had been finalized, Pat identified a scorecard of specific performance metrics against which department performance would be measured. Pat's department had always had goals, but in the past, Pat had formally shared them only with the people in his immediate workgroup. Now everyone in the entire department would know exactly what was expected of the group as a work unit.

- At this point, Pat decided that his team goals needed to be translated into individual goals; thus, he went through a formalized performance planning cycle with each of his employees. Pat asked his employees to prepare descriptions of their key responsibilities and activities and to take a first shot at setting goals in each of their performance areas. He then met one-on-one with each of his employees and discussed and formalized each employee's actual role, goals, and value-added responsibilities for the upcoming performance period.

- The meetings clarified for everyone the expectations and standards they needed to meet and gave Pat a chance to describe what success would look like for both the department and for the employees as individuals. The result was that his employees came away with a full understanding of what they needed to do to meet their new and more demanding departmental goals.

- In the final piece of his performance planning process, Pat focused on the important issue of support. He asked his direct reports what they needed from him to be successful. Pat was actually using the performance equation—performance = f(talent × motivation × support)—to make sure that each of his employees was equipped to succeed.

Going Forward

- At the end of the performance planning process, Pat and his staff were more clearly focused on what they had to do, both as a group and individually, in order to be successful. But once Pat and his direct reports agreed on performance expectations and the new performance period began, it was critically important for Pat to take the time to monitor and track the ongoing performance of each of his employees.

- Results-oriented leaders know that without accurate and up-to-date information on an employee's actual contribution to the organization, coaching can become ill-informed guesswork that doesn't achieve valuable results and may even harm an employee's performance.

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If you don't understand an employee's role in an organization, coaching can become ill-informed guesswork.

- Pat spent time observing and monitoring his employees' activities, as well as their output. Pat's actions helped his employees maintain their focus. At the same time, he reinforced appropriate behavior and was able to take corrective action when things were not going well.

- Pat was careful to observe both his employees' behavior and their performance at the individual and group level. And he made a point of managing by walking around to stay connected to his employees and observe their interactions with customers and other stakeholders.

Coaching on the Individual Level

- A truly effective coach needs to become proficient at tailor-making a feedback and support strategy for each specific employee. The way to do that is to understand each employee's level of talent and motivation. Based on the interaction of these two important factors, research has identified four different kinds of employees: dream employees, up-and-coming employees, underachieving employees, and change-or-go employees.

- Dream employees are highly skilled and highly motivated; they are one of any operation's best resources for getting better results. If you're working with dream employees, you need to think about your coaching role as being that of a nurturer. That is to say, as a leader, you need to identify new and challenging job assignments for your dream employees, provide them with regular doses of praise and recognition, offer additional responsibility, and empower them with additional decision-making authority.

- Up-and-coming employees are willing to work hard but may lack some of the specific skills and talents they need. To be effective in coaching them, you need to be both a teacher and a trainer. You need to observe their performance to identify the specific skills gaps that they have, then create meaningful training plans to help them acquire the talent they need for success. The goal is to do whatever it takes to help these employees become more proficient in the skills they need for better performance as quickly as possible.

- The next category, underachieving employees, will put your coaching skills to the test. Employees in this category typically have the skills, expertise, and the talent they need to do good work, but they're low on motivation; that deficit tends to prevent them from producing better results. To coach these employees, you need to be a motivator. You need to take even greater care to clearly establish performance goals and standards to create a greater sense of employee performance ownership. When you see underachievers engaging in desired behavior, be sure to reinforce it. But be willing to use constructive criticism, reprimands, and even negative consequences to move their performance in the right direction.

- Change-or-go employees are the toughest category. They not only lack motivation, but they don't have the ability or requisite skills to do their jobs. Coaching employees of this kind requires reviewing their employment records, tracking their performance, and ensuring that they have the proper tools and support to be successful. Then, it's imperative to clearly define in writing all performance changes

that the employee must make. You need to give the employee every opportunity to succeed, while making it clear that a failure to do so means termination.

  - Once this plan is in place, be sure to monitor the employee's performance on a daily basis, providing ongoing feedback and documenting the employee's actual contribution.

  - It's important to keep in mind that change-or-go employees are capable of turnarounds when they're properly coached and when they're confronted with the harsh consequences of nonperformance and failure to improve. But when the employee is not responding to attempts to foster improvement, your role as coach needs to shift to that of a disciplinarian and documenter. You need to formally prepare for employee demotion or termination.

  - Although it's always painful to see someone lose his or her job, if employees in your operation are underperforming, you have a moral and social responsibility to strongly address the issue. Make sure your human resources department is a partner in this action.

Pat's Conclusion

- Let's return to Pat's story and see how he did in coaching his own people. Pat made monthly one-on-one meetings part of his coaching modus operandi with great success. The collective performance of his department improved, and Pat's team met the company's goals.

- Here's a look back at what Pat did to improve performance in his department:
  - First, he realized the importance of coaching and feedback in developing his employees' talents.

  - Next, he assessed his own strengths and weaknesses and took steps to acquire the skills and support he needed to be a successful coach.

- Then, he clearly defined winning for his team, but equally as important, he used a performance planning process to define what each person needed to do for the team to be successful.

- Finally, Pat developed a tailor-made coaching strategy for each of his employees to provide the feedback, motivation, development experiences, and accountability to maximize individual performance.

- In 12 months, Pat became a better leader and a great coach. It all happened simply because he needed to get better results and was willing to take real action to do so. In the end, Pat was very coachable himself—and that made everything else possible.

Suggested Reading

Longenecker, "Coaching for Better Results."

Longenecker and Neubert, "The Practices of Effective Managerial Coaches."

Questions to Consider

1. If you are in a leadership position, are you comfortable providing ongoing and balanced performance feedback to your employees?

2. Do you tailor-make your coaching strategy to the needs of each individual employee and his or her current level of performance?

3. Do you take sufficient time on a regular basis to meet with your employees on an individual basis to reinforce effective and desired behaviors?

4. Do you take sufficient time on a regular basis to meet with your employees who might be struggling or who need corrective action to get their performance back on track?

Understanding Power Relationships

Lecture 44

Workplace power, authority, and influence shape the landscape of virtually every organization on the planet. Yet when it comes to these factors, people make three common mistakes: (1) failing to understand the formal authority and power attached to their current positions at work, (2) failing to take proactive steps to increase their personal influence, and (3) failing to effectively manage their working relationships with their supervisors. In this lecture, we will examine these issues to enable you to avoid these kinds of mistakes.

Power and Influence

- Power has many definitions, but a person or group has power when they possess the capacity to exert influence or control over the actions of others. They typically possess something that someone else desires.

- When we think about power, we frequently think about presidents, kings, CEOs, military leaders, and the like. But the truth of the matter is that we all possess some degree of power that is attached to our current position.

- Influence, in contrast, is power in action. Influence is the effect that a person or workgroup's actions have on the actual attitudes, beliefs, and actions of others.

- Although power is the capacity to affect others, influence can be thought of as the extent to which

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A high-ranking executive might have great power, but if it's not used effectively, his or her influence will be limited.

power is actually being put into use to affects others. For example, although the president of an organization may have a great deal of power, his or her ability to influence a particular employee's daily behavior might actually be quite limited.

- Power and influence are critical to any study of organizational behavior. And most people are absolutely fascinated by this topic—it's human nature.

Types of Power

- In 1959, researchers John French, Jr., and Bertrand Raven developed a classification of the bases of power. They identified five basic types of power: legitimate, reward, coercive, expert, and referent.
    - Legitimate power is the formal authority granted to people by their organizations because of their formal positions. Our supervisors have legitimate authority over us to assign work, review our performance, grant us decision-making power, and enforce company policies because of their position in our organization's chain of command. There is also legitimate power attached to the position that you hold.

    - Reward power is a person's ability to provide others with rewards, incentives, or inducements to influence their behavior. A leader's control of budgets, pay raises, bonuses, and promotional opportunities can have a powerful impact on the behavior of others when properly applied.

    - Coercive power is the opposite of reward power. People who possess coercive power in the workplace can influence others through the use of sanctions, punishment, and reprimands or by removing benefits or resources.

    - Expert power results from a person's special knowledge or skill that is prized and needed by others. If you're an expert, people will be willing to follow your lead because of the knowledge you possess, your ability to solve problems, and your ability to make sound decisions.

- Referent power refers to the potential influence that a person can have over others through strength of personality. It derives from our ability to connect with people and to forge strong and effective working relationships with them.

- The first three sources of power—legitimate, reward, and coercive—are collectively known as *position power*, because they are clearly tied to the position that a person holds in an enterprise. Let's apply that information to try to avoid the first common workplace mistake described earlier—not understanding the formal power of your current position. Consider these questions:
  - Have you taken the time to assess how much legitimate power and authority are attached to your position?

  - Have you determined the things you control, the decisions you can make, and the actions you can take of your own accord?

  - If you are in a leadership position, are you making full use of the rewards and resources you possess that can influence the behavior of others in positive ways?

  - Have you taken stock of the potential sanctions you have at your disposal to shape the behavior of the people reporting to you?

- The last two bases of power—expert and referent—fall under the category of *personal power*. Personal power is power that is tied back to what you know and who you really are as a person. An understanding of personal power can help you avoid the second common workplace mistake: failing to take proactive steps to increase this type of power.

Increasing Your Power

- As mentioned, it's important to know and understand the position power that you possess in your current job. You need to know what you have to work with and the boundaries that you must operate within.

- However, be careful not to make your position power the sole basis for getting work done because people will soon lose respect for someone who has no basis for power other than his or her title. Similarly, the use of reward and coercive power can make people compliant, but it doesn't necessarily translate into people being committed to what you are trying to accomplish.

- That's why it's imperative to develop your professional and technical expertise. People acquire power when they possess needed skills and information. Becoming an expert in areas that are critical to your organization's success is a surefire way to increase your organizational influence.

- Connections help, as well. You can increase your power by developing 360-degree working relationships, building strong teams, and creating strong social networks both within your organization and across your industry.

- Creating and building on a referent power base is something that most people can do if they are willing to make it a priority. Simple yet powerful people practices, such as making sure to learn and remember people's names, can go far.

Understanding Your Boss

- Let's discuss the third common workplace mistake: failing to effectively influence and manage your relationship with your supervisor. Research shows that people are generally quick to assess working relationships with their peers and subordinates, but they often fail to see the value in assessing their working relationship with the boss.

- Taking the time to understand what is working well and what needs work is an important first step toward better managing your boss. Here are some important questions to guide your assessment:
  - What does your boss do that helps your productivity?

    - What does your boss do that hurts your productivity?

    - What do you need from your boss that you are not getting?

    - What specific things are needed to improve the overall quality of your working relationship?

- Answering these questions will give you a starting point for developing your improvement plan to better influence your boss. Next, work hard to get to know and understand your boss. The two of you are linked together—whether you like it or not; thus, it's important to pay attention to how he or she operates. Think about such questions as:
    - What motivates your boss?

    - What are your boss's likes and dislikes?

    - How emotionally intelligent is your boss?

- Next, try to put yourself in your boss's shoes. Find out his or her performance goals and organizational expectations. When you know that your boss has overly aggressive goals to meet, an overwhelming workload, resource shortages, unrealistic timelines, or perhaps even his or her own bad boss, you can be more empathetic and offer the right kind of help.

Managing Your Boss

- Once you better understand your boss, several practices can help you improve the relationship. One such practice is to under-promise and over-deliver. Most bosses appreciate when their employees exceed expectations. When you deliver what your boss expects on an ongoing basis—or better yet, even more than your boss expects—you establish your credibility as someone your boss can depend on.

- It is also important to learn how to communicate effectively with your boss. Most bosses have a preferred style of communication. Some do all the talking, others listen, and others prefer reading. Most bosses also have a preferred channel for communicating. The important point is that you understand how to proactively interact with your boss in a fashion that he or she prefers.

- Take the initiative to make alignment sessions with your boss a regular occurrence, both to help you stay on track and to maintain your boss's coaching. Schedule short, 15-minute meetings with your boss once or twice a month to keep the channels of communication open. Use the sessions to discuss your performance and what you are working on and to solicit your boss's input.

- Never identify a problem or bring a complaint to your boss without having a potential solution in hand. Most of our bosses have a fair number of problems and issues on their plates on any given day, so don't be surprised if you get a less than warm reception when you go to your boss with yet another problem or difficulty. If there is an issue that you need to bring to your boss's attention, make sure that you properly frame it and get all the facts. Then, take the time to offer up your ideas or your potential solution to the difficulty.

- Finally, it is important to always show respect for your boss. Don't engage in gossip or backbiting. Other people are watching and listening. When word of bad-mannered behavior gets back to the boss, it can spell career disaster for the backstabber. It also causes other people to wonder what you might say about them when they are not around.

- In spite of all this advice, remember that, as a subordinate, there's only so much you can do to change your boss. If your boss puts you in a place where coming to work is more stressful and unproductive than it should be, then it might be time to consider leaving. But for most of us, taking proactive steps to help our bosses help us is a good move.

Suggested Reading

Cross and Parker, *The Hidden Power of Social Networks*.

Greenberg and Baron, *Behavior in Organizations*.

Questions to Consider

1. Have you taken the time to determine how much influence you actually have at work?

2. Do you understand the specific things you can do to increase your power and influence at work?

3. Have you taken the time to identify the specific behaviors and practices that represent "professionalism" in your current position?

4. Have you thought through and developed a plan to appropriately influence your boss in ways that will help you get your work done?

Handling Workplace Conflict
Lecture 45

Whether we like it or not, conflict is an inevitable part of organizational life. If you're in a leadership position or if you aspire to a leadership role, a great deal of your success will depend on how well you respond to and manage conflict among the people you work with. This lecture will discuss where conflict comes from and the areas in which it manifests itself. Then, we'll conclude by looking at a model to help deal with conflict.

Rising Workplace Conflict

- In a recent survey of American business leaders and other professionals, nearly 70% of the respondents said they believe that conflict in the workplace is on the rise. The respondents identified several reasons for this increase.

- First, there's the pressure factor. As organizations experience greater competitive pressure, the respondents said that they are constantly being asked to change, to do more with less, and to do everything faster. As jobs change, workloads increase, and the paces of people's personal lives accelerate, they have more pressure and stress. With more pressure and stress, our communication and coping skills can break down, making us bad-tempered.

- Then, there's the complexity and change factor. As organizations grow in size, they increase in complexity. The respondents said that it's becoming a greater challenge to have a shared vision and strategy understood by all, clearly defined roles and responsibilities, and high levels of teamwork and cooperation.

- Another major source of conflict is the competition factor. The respondents said that as their organizations experience rising external competitive pressure, they also experience an increase

in internal competition. When people are competing for scarce resources, such as budget allocations, rewards, and promotions, healthy competition can easily degenerate into open conflict.

- The leadership factor also plays a role in conflict. As their organizations become more complex and competitive, the respondents reported, there is a rising need for dynamic leaders to step up and realign their leadership skills to meet the challenge. But many individuals are not practicing the fundamentals of leadership in their rapidly changing organizations, and the natural result is unnecessary and counterproductive conflict.

- Finally, there is the social factor. The respondents reported a greater range of workplace attitudes, values, and personalities that increase the likelihood of interpersonal tension and conflict at work. Society is changing, and it's inevitable that the workplace will change with it. If those changes produce tensions in society at large, they will undoubtedly appear the workplace, as well.

Types and Levels of Conflict

- There are two primary types of conflict: substantive or task-based conflict and emotional or affective conflict.

- Substantive or task-based conflict exists when individuals and groups have differences of opinion. They may differ over such issues as facts, goals, strategies, plans, policies, processes, roles, resource allocation, or decision making. A conflict is substantive when the issues driving the disagreement are tangible, material, and reasonably concrete. Selecting a new software vendor or developing the budget for a project are both substantive issues.

- Some substantive conflict may be inevitable at times. These types of conflict can be beneficial if people are focused on sharing their ideas and opinions so that they can get at both the truth and the best solution to a problem or disagreement. But these differences of opinion can

escalate into tense arguments if not properly managed. When this happens, unchecked conflict over issues of substance can damage and even destroy working relationships, teamwork, and careers.

- Handling substantive conflict is all the more challenging because of the other kind of conflict: emotional or affective conflict. This type of conflict exists when there is tension between people because of personality differences or a breakdown in an interpersonal relationship. It's just as inevitable as substantive conflict, but it's much more volatile. You need to take special care to identify it and take action to minimize it.

- To make matters even more complicated, conflict within any organization can break out at several different levels: intergroup, intragroup, and interpersonal.
    - Intergroup conflict exists when a struggle takes place between groups, teams, departments, or even different operations within the same organization.

    - Intragroup conflict exists when there is conflict within a workgroup or team. It is not uncommon to see a workgroup or team fracture and split up into subgroups.

    - Interpersonal conflict exists when two people are caught up in a skirmish over work or even over a non-work-related issue. This type of conflict is often at the root of other forms of conflict.

- It is important to remember that conflicts can be substantive, emotional, or both at all three of these levels, with each level presenting its own set of challenges.

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Interpersonal conflict occurs between two people and can happen for work-related or non-work-related reasons.

Preventing and Handling Conflict

- Without effective leadership, virtually any substantive issue in an organization can become a conflict. What steps can you take to avoid unnecessary workplace conflict and better handle it when it occurs?

- First, it's imperative to create individual role clarity to ensure that all employees understand their job responsibilities and authority and who they report to in the organization structure. This clarity can go a long way to help prevent conflicts over these important issues and can have a powerful impact on motivation and teamwork.

- Next, make it acceptable for people to have and express legitimate differences of opinion, especially when discussing substantive issues in the workplace. Encourage people to be open and candid when they're talking about setting goals, developing plans, improving processes, solving problems, or discussing any issue that is important to your operation's success.

- You also need to work hard to know, understand, and address the problems that confront your workgroup because of organizational policies, procedures, and practices. In many organizations, ineffective and outdated modes of operation can create real difficulty for people trying to get their work done.

- Another essential task is to train yourself and the people you work with to develop good problem-solving and conflict resolution skills. It is useful when members of a workgroup or team have an agreed-upon problem-solving process and conflict resolution model that they can all use when needed.

- Finally, it is critically important that you know yourself and how you handle and work to resolve conflict. Do you know your strengths and weaknesses in handling workplace conflict? Do you know and understand how your actions can affect others when resolving conflict? Do you know your preferred style of resolving conflict? You need that kind of self-awareness if you are to successfully turn workplace disagreements into positive outcomes.

The Thomas-Kilmann Conflict Resolution Model

- Since 1974, the Thomas-Kilmann conflict resolution model has helped many people understand the various strategies that can be used to resolve conflicts—whether they are parties to a conflict themselves or observers trying to resolve a conflict among others.

- Developed by management professors Kenneth Thomas and Ralph Kilmann, the model focuses on the interaction of two critical behaviors: assertiveness and cooperation. Assertiveness can be described as the strength of a person's desire to satisfy his or her own concerns and needs in pursuing a desired outcome. Cooperation, in contrast, is a person's willingness to satisfy the concerns and needs of others involved in the conflict who are pursuing their own desired outcomes.

- The interaction of these two variables creates five conflict-resolution strategies: competition, accommodation, avoidance, compromise, and collaboration.
    - The competition approach is high on assertiveness and low on cooperation. With this strategy, a person in a conflict pursues his or her own concerns in a fairly aggressive fashion and often does so at the expense of other people involved in the conflict. The problem with using the competition or forcing approach is that the conflict results in a winner and a loser.

    - In contrast, accommodation is a style in which a person is unassertive and willing to be highly cooperative. Here, individuals give lower priority to their own needs and concerns to satisfy the needs and concerns of others. But over time, having unmet needs has a degrading effect on performance, job satisfaction, and attitude.

    - An avoidance strategy means that a person is both unassertive and uncooperative when it comes to attempting to resolve a conflict. The avoidance approach suggests that a person shuns conflict at all costs and is willing to ignore or disengage from

an issue regardless of its importance. The warning attached to an avoidance strategy goes back to the simple fact that most problems, conflicts, and crises do not go away without action.

    - A compromising strategy takes a moderate position on the issues of assertiveness and cooperation. When people take a compromising approach, it means that they are willing to take steps to find a mutually acceptable solution. But the warning here, especially in the case of a substantive business conflict, is that a compromise solution to a problem might not be a real solution at all. It may just put off the underlying conflict for another day.

    - Finally, there's the collaboration strategy, which makes a tremendous amount of sense in most business scenarios. When people collaborate to resolve a conflict, they explore the actual disagreement to solicit insight from one another. Clearly, if you're trying to resolve a conflict between others, this is the ideal scenario. But this strategy takes more time, more patience, and more effort than all of the other tactics—which can be challenging in some situations.

- The real benefit of the Thomas-Kilmann model is that you can use its five approaches to analyze any workplace conflict you see or are involved in, then decide how you can best respond to it. The next time a workplace conflict occurs, start by determining whether it is substantive or emotional and at what level the conflict is taking place (intergroup, intragroup, or interpersonal). Then, determine the levels of cooperation and assertiveness of the parties. You can then use the five resolution strategies to determine how you will approach the conflict.

Suggested Reading

Bazerman and Neile, *Negotiating Rationally*.

Yourdon, *Death March*.

Questions to Consider

1. What are the primary causes of the conflicts that you experience at work?

2. How does workplace conflict affect your ability to get your work done?

3. When you are confronted with a conflict at work, how do you respond? Do you understand your strengths and weaknesses in resolving conflict?

4. When you are confronted with a conflict, do you have a systematic approach to resolve or alleviate it?

Ethics and the Bathsheba Syndrome

Lecture 46

Enron, Tyco International, Arthur Anderson, Global Crossing, Adelphi Communications, Bear Stearns—these company names have become synonymous with scandal. In each of these cases, corporate leaders created company cultures that were driven by exceptionally unethical behavior. News headlines today reveal unethical business behavior still goes on en masse. Even in organizations with strong ethical guidelines, temptations can lead employees to immoral decisions. This lecture will examine where those temptations come from and close with some strategies to protect yourself and your coworkers from them.

The Practicality of Ethics

- Business school discussions of ethics have a way of becoming abstract and philosophical. But in the business world, ethics are realistic and practical because good ethics are good for business and for your career.

- There is a well-established link between an organization's ethical behavior and its financial performance. Although there might be short-term financial gain to be had by cheating, over the long run, ethical behavior delivers better financials.

- Having a reputation as an ethically responsible enterprise makes it easier to retain and attract customers because most people want to do business with an organization that they can trust and believe in.

- Organizations that create ethical and trusting cultures have higher levels of teamwork and more effective communications. This makes it easier and faster to drive organizational change and transformation, which can be a real competitive advantage in most industries.

- In the current talent wars, organizations that act in socially and ethically responsible ways have a leg up on attracting and retaining top talent. Organizations that frequently show up on lists of America's most ethical companies are not only doing the right thing, but they are great places to work and very profitable, high-performance operations.

The Origins of Ethics

- The starting point for ethical decision making is our moral values, that is, our fundamental beliefs concerning what is good or bad, right or wrong, and acceptable or unacceptable. Our moral values are molded to a great extent by our religious beliefs, our training, and the influence of our families and home environment, especially during our developmental years.

- Moral values are critically important because they become the basis for our personal ethics, which are the standards or codes of conduct that guide our decision making and behavior. Stated differently, our ethics represent our personal beliefs about whether an action or decision is right or wrong.

- Your personal ethics might address such issues as your stance on honesty and lying, the use of confidential information, and whether it's acceptable to use alcohol or drugs.

Dealing with Ethical Issues

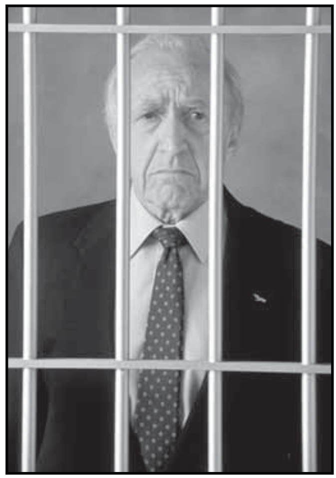
- When ethical issues are in play, your first action should be to stop and think. Then, gather relevant information and facts so that you fully understand both the situation and the context of the decision that needs to be made.

- Next, make a list for yourself of the options that are open to you. Ask: Is there really no alternative other than making a questionable choice? Have you considered every possible course of action?

- Then, you need to clearly identify the legal and ethical implications of each course of action in your decision-making options. This requires that you consider all the stakeholders that are affected by each alternative and the consequences of the various options.

- You also need to make sure that you consider unintended consequences in your deliberation. What if your decisions don’t turn out as planned?

- It is essential to ask the following questions when making decisions:
    - Is this decision legal?
    - Is this decision in line with my organization’s values?
    - Is this decision in line with my own values?
    - How will this decision affect the stakeholders?
    - What are the upside and downside of this decision?



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One test to see if an action is ethical is to consider its legality.

- Bear in mind that the answer to an ethical dilemma might have already been made for you. If you look at your organization’s code of conduct, union contract, or policy manual, you may find that some decisions have already been preprogrammed.

- Next, seek wise counsel and the input of knowledgeable and experienced people whom you trust when making decisions involving ethical issues. There is no substitute for getting a second opinion to test your thinking and approach in making a decision with serious ethical consequences.

- Finally, when making a decision with ethical implications, ask yourself: What would our board of directors or my mom have to say about this decision when they find out about it? Pay attention to your instincts.

“I Don’t Know What I Was Thinking”

- Though it’s easy to outline a guide for thinking your way through ethical decision making, in the moment, it may not be so simple. Think about how often you see people in the news who’ve been caught behaving unethically and consider how often you hear them say, “I don’t know what I was thinking!” Thinking your way through an ethical dilemma isn’t always easy, and the temptations to cross the line can be surprisingly strong.

- As a general rule, organizations work hard to hire principled people, and most people who work in organizational America are basically ethical people. But the unsettling fact remains that any one of us could get caught up in doing wrongful, unethical, immoral, and even illegal things if we are not vigilant.

- This statement is exemplified by something called the *Bathsheba syndrome*. To understand this principle, we must go back to antiquity and take a look into the life of Israel’s King David, an important figure to members of the Jewish, Christian, and Islamic faiths.
    - David had early success and enjoyed a career of exceptional, principled, faith-based behavior.

    - But he eventually made unethical decisions. First, he stayed at home during a time of war, and second, he committed adultery with Bathsheba. This cost him dearly.

    - Bathsheba became pregnant, and though David attempted a cover-up, his actions were eventually made known by a whistleblower named Nathan. Then, a series of troubling events rocked both King David’s personal world and his kingdom.

- David took his eye off his job and made decisions based on what he wanted, not what was best for his kingdom. He should have been at the front with his army, not living a comfortable life at the palace. His position as king exposed him to temptation and enabled him to act on it in a way that otherwise would not have been available to him.

- Additionally, David mistakenly believed that he had the power to cover up his wrongdoing—just as the executives at Enron, Global Crossing, and Bear Sterns believed.

- Every position we ever hold over the course of our careers will bring with it specific temptations—specific Bathshebas. We need to handle them appropriately if we are to avoid ethical failure.

Protecting Your Ethics

- Though temptations abound, research with focus groups has revealed some specific actions you can take to stay on solid ethical ground. You can use these for yourself, but you could undertake most of them for a department or team, as well.

- To start, develop a list of the various ethical temptations that you face in your current work position. This process is called *temptation mapping*, which means taking the time to specifically identify the Bathshebas that confront you in your current position. Temptation-mapping exercises with business leaders consistently uncover common workplace temptations, including falsifying data, abusing an expense account or corporate credit card, engaging in inappropriate sexual relationships, stealing, and offering or accepting bribes.

- Once you know what you're up against, develop your situational awareness. The purpose of this step is to avoid putting yourself in circumstances where you will be exposed to harmful temptations and prone to act on them. If King David had had better situational awareness regarding his temptations, he might not have stayed in his palace while his army was off at war—and he certainly wouldn't have invited Bathsheba to stop by for a visit.

- Another important guideline is to make yourself accountable. It is critically important to foster both personal and professional accountability with a person strong and honest enough to be your mentor, friend, and watchdog. Many people, especially senior leaders, get caught up in wrongdoing at a time in their lives or careers when they are experiencing a sense of isolation and lack real friends that they can count on. When confronted with an ethical trial or dilemma, immediately tell a trusted confidante.

- Another important way of protecting yourself from the temptation to behave unethically is to keep your financial, physical, and emotional houses in order. Doing so will make you less susceptible to the lures of greed, jealousy, addiction, or lust.

- Here's another tip: Beware of the trap of being emotionally expansive. A good psychologist will tell you that people who are emotionally expansive feel that whatever they have is never good enough. They always want more of everything, without appreciating what they already have. We can all relate to this to some degree; on any given day, we may wish we had a new car, a promotion, or a better home. But if we think this way all the time, we are destined to be in a constant state of frustration over what we don't have instead of being thankful and appreciative for what we do have.

- Finally, when making a decision about whether to do something you consider to be in a gray area, questionable, or even flat-out wrong, ask yourself this critically important question: What are the long-term consequences of this decision to my character, profession, career, and family when others find out about my actions? The odds are that people will find out.

Suggested Reading

Blanchard, *Leading at a Higher Level*.

Ludwig and Longenecker, "The Bathsheba Syndrome."

Questions to Consider

1. Think of a successful leader you have worked with during your career who had a major ethical failure. What was the failure, how did it affect the leader's career, how did it affect your view of this person as a leader, and what do you believe was the cause of the failure?

2. Have you taken the time to identify the specific ethical, moral, and legal temptations that are attached the current position you hold?

3. Have you developed personal guidelines that will prevent you from getting caught up in these temptations?

4. What specific things do you believe you need to do to maintain your ethical compass?

Leading Real Organizational Change

Lecture 47

Many organizations faced with grave threats keep behaving the same way that produced their problems in the first place. They just keep doing what they've been doing, hoping that their problems will go away. But change within an organization is unavoidable and essential. Anyone who holds a leadership position in an organization, or hopes to someday hold one, absolutely must learn how to get people to change the way they do things. In this lecture, we'll look at some research and ideas about organizational change that will help you make it happen.

Drivers of Change

- Today, organizational change is driven by such factors as new growth strategies, international expansions, business downturns, mergers and acquisitions, and retrenchment strategies. These strategic choices and events can require a wide variety of changes, including major restructurings, workforce reductions, new reporting relationships, the opening and closing of facilities, more aggressive goals, and cost-containment initiatives.

- Technological advances are also a tremendous driver of change. As new, speedy technologies make even newer, speedier technologies possible, companies need to reorganize themselves constantly to react or take advantage of new opportunities.

- As soon as your company changes, its competitors will adapt in order to keep up, which will force your company to change yet again. Today's business environment is relentlessly dynamic, and that requires our organizations to constantly realign their strategies and structures to be successful.

Obstacles to Change

- If change is so important, what makes achieving it within an organization so difficult? In the words of Dr. John Kotter of the Harvard Business School: "Evidence is overwhelming that the central challenge of change is not strategy or systems or culture. The fundamental problem is changing the behavior of people." In other words, individual behavior changes are essential for organizational behavior changes. Yet people in organizations often resist change. That resistance has many causes and can take many forms.

- Change can bring with it great economic insecurity, causing people to worry about losing their jobs and livelihoods. We often don't want to change because we're afraid of what it might mean for us financially. Other fears emerge, as well: fear of the unknown; fear of failure; fear of becoming obsolete; and fear of losing power, control, and workplace friendships.

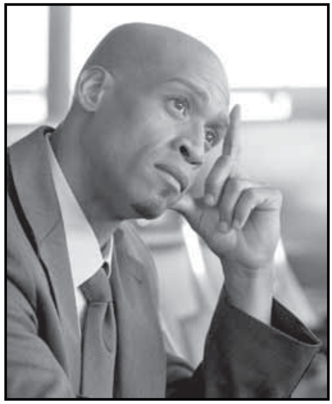
- To make matters worse, people within an organization are not always told why changes are necessary or given an opportunity to ask questions about how the change process will work. They may not have much confidence or trust in their leaders to begin with, as a result of failed change initiatives in the past. Lacking good reasons and uncertain of the outcome, they're naturally less than eager to disrupt their lives.
    - Illustrating this point, a mid-sized service organization recently implemented a new compensation system that was received with great resistance and angst by the employees.

    - The goal of the new compensation system was to increase wages to make the company more attractive in the recruiting process and more capable of retaining employees.

    - The company wanted to put more money in its employees' pockets, yet it failed to put a credible leader in charge and take the time to fully explain the reasoning behind the change.

- In addition, no one explained to the employees how the new system would operate or answered their questions prior to the rollout.

- In this situation, people resisted the opportunity to make more money because of past practices and how the change was presented to the workforce.



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Employees confused by a change may become resistant to it.

- Mid- and low-level employees aren't the only source of resistance to change, however. The leadership of an organization can be just as reluctant to adapt. In 1963, Harvard historian Dr. Alfred DuPont Chandler wrote an outstanding book entitled *Strategy and Structure*. Chandler found that organizational leaders tended to allow the status quo to rule until they were forced to change out of necessity. Businesses took action only when they were confronted with the harsh reality that their current strategies for doing business were no longer working in the changing marketplace.

Driving Meaningful Change

- Meaningful change in any organization—whether it is strategic, tactical, or operational change—requires effective leadership. When change is needed, many organizational leaders reach for a formal organizational improvement process. These are popular in the business world today and include such strategies as Lean Thinking, Six Sigma, Ford's quality operating system, *kaizen*, and total quality management.

- Other leaders use less formal methods, some of which can be aggressive, even confrontational. They send out forceful, demanding e-mails; give passionate, burning platform pep talks;

engage in screaming, fist pounding, and fear mongering; or simply issue mandates from on high. All these methods are capable of creating a flurry of activity, but unless they're applied in an effective and perceptive way, they are unlikely to produce desired and sustainable change.

- In fact, it has been estimated that only around 20% of all organizational change initiatives achieve their desired outcomes, which is a sobering thought. That means that 80% of the time, instead of changing, leaders who are trying to achieve change are actually wasting time, frustrating people, losing credibility, and burning precious organizational resources.

- Inspired by his reporting on health care, writer Alan Deutschman chronicled research findings and observations on change in a book entitled *Change or Die*. He found that facts, fear, and force alone don't drive real and sustainable change in people's lives. Deutschman introduced three dynamics that must be in place for real change to take place: relationships, repetition, and reframing.
    - According to Deutschman, if we are to change, we must have a strong relationship with someone that can give us hope that the change we need to make is possible.

    - We also need repetition. With direction from the person who is guiding us through the change, we need to learn, practice, and master the activities and actions that will allow the changes we are trying to make.

    - By reframing, Deutschman means that the person helping us though the change must help us form new ways of thinking about and understanding our situation. Reframing is needed to help people move from thinking and saying, "I hate this change" to "This change is going to put us in a better position."

- Deutschman's approach takes more time, effort, and energy. But the change it creates is real and sustainable, which should be the goal of every organizational and individual change effort we engage in.

A Study on Change Initiatives

- In the book *The Two-Minute Drill*, researchers analyzed more than 1,000 successful and unsuccessful change initiatives and found some interesting patterns. In this research study, the people who participated were a cross-section of executives, middle managers, and front-line leaders. The participants identified both a successful and an unsuccessful change initiative that they had been part of during their careers.

- The first standout finding was the fact that the leaders made problem solving the focus of change. Organizations must do things differently when their current activities are not working, whether they're experiencing a revenue shortfall, exploding costs, poor customer service, or lack of quality. Although all these issues require change, the real issue is solving the problem.

- The second important finding was that although leadership is essential to achieving organizational change, not just any leadership will do. Real and rapid change or problem solving requires leadership that is effective, trustworthy, and hands on. The leaders of successful change initiatives were focused, energized, skilled, and passionate about actually making things better. Conversely, failed change efforts were almost always poorly led, with the person in charge often just going through the motions of the change effort.

- Successful change initiatives also always had two other important qualities: a sense of urgency and speed. A sense of urgency conveys to people the importance of the effort. It can easily be translated into the need for speed, which gives the effort forward momentum.

- Another finding represented some new thinking on the subject of achieving organizational change: Leaders of successful change efforts take the time to know and understand what they're up against when embarking on any change initiative. They determine how well their skill sets and the skill sets of their teams stack up against the challenge.

- Still more vital elements of a successful change initiative are teamwork and talent. When you think about the problem-solving activities needed to drive change, it makes sense that you need motivated people who are able to work together and who have the requisite skill sets for the needs of your project. Among other things, you probably need people with good IT skills, others who are good analysts, and people who have good training and facilitation skills.

- The researchers also found that successful plans invariably involve careful monitoring. Leaders of successful change observe and measure both individual and team performance to ensure that the right activities are taking place to move the change forward. Knowing that they are being held accountable for their behavior and performance encourages people to give the change initiative their best efforts.

- Finally, the researchers found that successful leaders of organizational change provide feedback, coaching, and rewards to shape and reinforce the actions and behaviors that are driving the change. Careful monitoring enables leaders to know when desired results are being achieved and to call attention to them, which produces justifiable pride and satisfaction in the people whose hard work made the change possible.

Suggested Reading

Kotter, *Leading Change*.

Longenecker, Stansfield, and Papp, *The Two-Minute Drill*.

Questions to Consider

1. Think of successful change that you were part of at work. What was it that made it so successful? What lessons can you draw from this experience?

2. Do you approach change with a problem-solving mindset?

3. Do you know your own strengths and weaknesses as a change agent/leader?

4. Is there a problem at work right now that you need to solve? What will be your plan of attack to make real change happen sooner rather than later?

Lifelong Learning for Career Success
Lecture 48

Though the most important ingredient for career success is a track record of delivering desired results, another critical factor is your ability to develop your skills and talents to meet the changing demands of your job. Furthermore, to be of any real value, our knowledge of organizational behavior needs to influence both our thought processes and the way we behave. To that end, this lecture will discuss the barriers that get in the way of our ability to change, learn, and develop and how to overcome them.

The Essentiality of Learning

- In our data-driven world, information doubles every five years, and organizations rapidly change to keep up with the hyper-dynamic marketplace. Performance expectations keep rising, and the average worker will change jobs between 7 and 10 times during his or her career.

- It should therefore come as no surprise that we must all make lifelong learning and professional development a real priority. The onus for developing yourself falls squarely on your shoulders.

- Although your boss and organization can help guide you and provide important input and resources, professional development comes down to your willingness to take control of this important part of your work life. Remember that delivering better results for your organization requires improving your talent.

- Successful people across virtually every discipline tend to be lifelong learners who place a real priority on their intellectual and professional development.

- Those involved in human resources and training frequently ask: Why don't people take their professional development more seriously? Some answers derived from surveys include the following:
    - Extreme time pressures, bad bosses, and the fact that many people receive little or no performance feedback

    - Organizational cultures that do not promote or encourage employee development

    - Organizations that demonstrate a willingness to accept poor performance and the status quo

    - Companies that fail to invest resources and create processes to promote learning

    - People who don't take the time for self-reflection and self-appraisal

    - Out-of-control egos that prevent people from realizing that they are in need of some work,

Breaking through with Learning

- We all face barriers that can get in the way of acquiring new skills to meet the demands of our jobs, refining our existing talents, or developing greater expertise in an arena that can help advance our careers. One way to counter this is to make a habit of engaging in ongoing learning through a five-part process.

- First, it's imperative that we take time every day to reflect on what we're doing and how well we're doing it. This means that we become more self-monitoring and aware of our behavior, which is a cornerstone of being an emotionally intelligent person. In this regard, it's important to conduct a daily S.T.O.P. in order to spend sufficient time planning and developing a performance script for each day.

- Second, it's also imperative that we seek out and receive ongoing feedback from people who are in a position to help us improve our skills. Research tells us that many professionals do not get sufficient feedback and coaching on their performance; thus, we need to become more proactive in this regard. If your organization does not provide you with satisfactory feedback, you need to create your own feedback mechanisms. Take the time to build 360-degree working relationships to increase your opportunities to get accurate and candid feedback.

- Third, we need to learn from our mistakes and not allow them to become habits or lifestyles. In the words of great American film actor John Wayne: "Life is tough, but it's tougher if you're stupid!" A person who is ignorant doesn't know what to do, but a person is being stupid when he or she knows what to do and, for whatever reason, doesn't do it. When we find ourselves making the same mistake time and time again, we damage our own performance and run the risk that the mistake can become a deep-rooted habit.

- Fourth, ongoing learning can take place when we make seeking out new and better ways of doing things part of our daily approach to work.
    - There is much to learn by asking good questions and by sharpening our listening skills.

    - Working closely with talented people and learning how to emulate their thinking and behavior can help you absorb good skills and habits.

    - Newspapers and periodicals can provide us with information about current industry trends and best practices that are relevant to our jobs.

    - When we have great working relationships, we can draw on them when we have a question, need input in solving a problem, or simply need a sounding board on an important decision we're about to make.

- Finally, leaders and professionals who are serious about ongoing learning will create accountability systems that motivate and encourage them to engage in many of the practices we've discussed in these lectures. They will have regular contact with an accountability partner, or they may even go so far as to set up their own personal board of directors. Such systems are useful for discussing what we need to keep doing, stop doing, and start doing to improve our performance.

Breaking through with Professional Practices

- The second major step to keep yourself growing in your career is to adopt smart professional development practices that will improve your talent. Although your ongoing learning practices can go a long way to improving your performance, from time to time, we all need to conduct a strategic S.T.O.P. to assess whether our talent base is where it needs to be. If it is not, we need to figure out how to address the issue.

- First, it's important to conduct a needs assessment of yourself to determine your level of proficiency in the skills that are most important for success in your current position. There's a good chance that when you had your most recent formal performance appraisal, your boss identified an area or two that could use some work. Once a deficiency has been identified, set a specific learning objective for that particular skill. The more specific, the better.

- As soon as you've set a learning objective, it's time to create an improvement plan to help you develop the skills you need to be more successful. High-performance professionals craft development plans that are specific to the skills they are trying to perfect.

- In developing your plan, you might want to seek out formal training and education programs around the particular skill that needs work. Start by familiarizing yourself with the organizational training and development programs that your company offers. You might also be able to find a seminar or workshop offered by a local consulting group, university, or community college.

- After completing a formal education program, make sure you take steps to increase your ability to retain and apply the information you learned. Include some specific actions from the training that you can make part of your S.T.O.P. process.

- Within your organization, such activities as cross-training, taking on assignments to serve on improvement teams, and participating in on-the-job training programs might provide excellent learning opportunities. In addition, organization-sponsored community service, outreach programs, and volunteer efforts in the community can be amazing skill-development opportunities.

- Just as in the case of your ongoing learning, once you have taken the time to create a professional development plan, it is important that you create accountability around it. Here is where having a great working relationship with your boss, having an accountability partner, or having a personal board of directors can come in handy yet again. For your development plan to work, there must be specific

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Volunteering is an often-overlooked way to develop your skills and talents.

action, ongoing feedback and reinforcement, and accountability for action. Otherwise, the hustle and bustle of daily work will squeeze out these important learning opportunities.

Mentoring

- Never underestimate the power of having a mentor and being a mentor. Successful people almost always have a network of mentors to help them make good decisions, plan more effectively, and create and maintain professional networks. Successful people know that mentoring other people helps them keep their feet firmly on the ground, causes them to stay humble, and helps them stay connected to the things going on around them.

- As we move through life pursuing our careers, it is critically important to remember that relationships are the cornerstone of our careers and the foundation of life. Each one of us needs to take responsibility for being an effective mentor to the people around us, people who are less fortunate than us, and people who have something to gain by having access to our experience, counsel, support, and network. At the same time, each of us needs to have a mentor in our lives for the same reasons.

- Whether it's improving your leadership skills, developing your emotional intelligence, boosting your coaching or team-building abilities, or developing any of the other skills that we have discussed, make use of that special mentoring relationship to develop the knowledge and talents that are most critical to your success.

Suggested Reading

Blauner, *Coach*.

Gordon, *Training Camp*.

Questions to Consider

1. What specific practices does your organization have in place to help facilitate employee development?

2. Do you have a plan for your development around specific needs, and are you taking advantage of the development tools that your organization provides?

3. Do you take time on a daily basis to reflect and learn from the experiences of each day?

4. Do you have a mentor, and are you mentoring others in your organization to help them be successful?

Critical Business Skills: Marketing

Ryan Hamilton, Ph.D.

Critical Business Skills: Marketing

Scope:

To the casual observer, marketing can resemble a series of random and disconnected actions. Why did a firm choose to sell through a particular channel? Sponsor a particular event? Cast that actor in its commercials? Locate its stores at a particular location? Price at a particular level? Bundle its offerings with other products or services? If it is bewildering to watch how established companies with long histories of success make such decisions, what chance does the small business owner have of developing and following through on a coherent marketing plan?

When viewed through the proper lens, however, this cacophony of seemingly disconnected decisions comes into focus. As it turns out, there is a proper sequence in which marketing decisions should be made—an order that can be imposed on all the choices marketing managers must make.

All marketing decisions can be divided into two groups: those that affect the firm's marketing strategy and those that concern the tactics it will use to implement this strategy. These two types of decisions are not equal: Strategy takes precedence over tactics and, thus, must always be decided first.

This section of the course is structured around this distinction. In the first lectures, we will discuss how to develop a marketing strategy by thoughtfully answering three basic questions: Who are your customers? What do they value? How can you give them what they value better than the competition? If you understand the answers to those three questions, you have a marketing strategy.

We will cover a number of topics on our way to answering the three all-important questions: segmentation, targeting, positioning, sources of value for the customer, how to grow a market, and sources of value for the company. After we have discussed marketing strategy, we will dive into marketing tactics. These topics include products and services, branding, pricing, and communications, including advertising, social media, and word of mouth.

At the conclusion of these lectures, we will discuss the basics of market research. In particular, you will learn the many different types of methods and data you have at your disposal for getting insights into who your customers are, what they value, and how they make decisions. Throughout the lectures, these principles are illustrated with examples from industry and from academic research in marketing, psychology, and behavioral economics.

Marketing done well is the basis on which companies grow, innovate, and fend off competition. Marketing done poorly, however, is hard to distinguish from throwing money out a window. This section of the course is designed to provide you with the tools you need to understand marketing and make sound marketing decisions. ■

What Is Marketing?

Lecture 49

The term *marketing* is often defined too narrowly. Many people, for example, treat marketing as if it were just advertising—something that's done after all the other important decisions about a product have been made. Others see marketing as synonymous with sales. Again, according to this view, all the important decisions are made first; then, marketing is brought in to push the offerings onto customers. But marketing is much broader than either advertising or sales. Marketing is the process of facilitating exchanges that create value for customers, collaborators, and the company. And marketing creates this value by developing an understanding of what customers want and need. In this lecture, we'll explore the types of value that customers seek.

Defining *Marketing*

- The definition of *marketing* as the function of a business that creates value for customers and the company is not universally accepted. Many people—even business experts—believe that value is created by innovations; in other words, value in a product is produced by scientists and engineers working in a lab.

- This disagreement is rooted in a difference of opinion over what constitutes value from a business perspective. Some people view value as something intrinsic to the offering. In this view, if a company adds features to an offering—gives it a faster processor or makes it more fuel efficient—then the value of that offering is increased. However, adding a new feature increases the value of a product only if customers decide that they value the improvement.

- In other words, an offering's value should be determined only from the perspective of the customers who are willing to buy it.
    - If we use this customer-centric definition of value, then we understand that innovations developed in a lab are not intrinsically valuable. An innovation must be matched with a

set of customers who will appreciate it; it must be explained to those customers in a way that they will understand; it must be priced in such a way that customers will be willing to pay for it; and so on. Those are all functions of marketing.

- ○ Marketing is what turns something with the potential for creating value into something that actually creates value for the customer and the company.

- It's true that occasionally, an innovation comes along that essentially sells itself; it's so great that people flock to it. But it is also distressingly common for groundbreaking innovations to fail the first time in the market, only to be replaced later by a better-marketed imitation. The success of the PalmPilot over earlier digital assistants created by Apple and Motorola serves as an example.


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The manufacturer of the PalmPilot was extraordinarily successful with a device that was actually less complex than other personal digital assistants on the market at the time.

Types of Value

- It's a mistake to assume that if you like a product, your customers will, too. The fact is that people are different, and the people who make marketing decisions about products and services are likely to be different from their customers. If you're going to be successful in marketing, you need to respect and try to understand those differences.

- Instead of basing marketing decisions on your own preferences, it's important to recognize that there are different types of value that customers may get from an offering. In particular, we can identify four types of value: functional, monetary, social, and psychological.

- ○ Functional value is the degree to which an offering fulfills its purpose or solves a customer's problem. For example, the functional value of bottled water is that it quenches thirst and hydrates. Products and services differ in terms of their functional value to the extent that they are better at fulfilling their functional purpose.

- ○ Monetary value is a function of the price paid for an offering relative to its perceived overall worth to the customer. As such, monetary value is not completely distinct from the other sources of value but, rather, invites a trade-off between those other types of value and monetary costs. Monetary value can provide a compelling reason for choice.

- ○ Social value is the extent to which owning a particular product allows consumers to connect with others.

- ○ Psychological value is the extent to which owning a product allows customers to express themselves or make themselves feel better. Sometimes, all customers are looking for from an exchange is to feel appreciated, respected, comforted, or hopeful.

- The key insight here is not just that people derive value from these four sources but that these sources of value are not all equally important. In fact, the importance of each source of value depends on the customer. For some people, one of these sources of value, such as monetary or functional, is nearly always paramount.

Understanding Customers

- One way for marketers to use these four sources of value is to consider whether their target customers are, on average, more motivated by functional, monetary, social, or psychological value when they shop. Some people have a primary motivation, and your target customers may be among them.

- It is much more common, however, for any particular customer to give these different sources of value greater or lesser weight depending on the purchase. When shopping for a washing machine, for example, you might seek functional value; you want a machine that is energy efficient and reliable. When buying office supplies, you might be primarily driven by monetary value. You may not necessarily buy the lowest-priced offering, but you want to make sure you get a good price.

- The key for marketers is to determine which source of value their customers are seeking in a particular transaction. If you are mistaken in this determination, you may be wasting your marketing efforts.

- You shouldn't necessarily assume that your customers are primarily motivated by monetary or even functional value. In many cases, these sources of value may be the most important factors customers consider, but not in all cases.
  - In recent years, some large hospital systems have moved away from a policy of never admitting mistakes to patients for fear of lawsuits to a policy of being open and honest with patients when mistakes are made.

  - This shift recognizes that some malpractice suits might be motivated by a desire for psychological value rather than monetary concerns. Under a full-disclosure policy, hospitals provide this value to patients by admitting mistakes, sincerely apologizing, and keeping patients fully informed. The result is that malpractice suits have dropped dramatically.

  - For example, in 2001, there were 262 lawsuits against the University of Michigan Health System before it adopted a policy change. By 2007, after the change, the number of lawsuits dropped to 83.

- Understanding your customers' primary source of value also allows you to position your offering in a way that provides them with a reason for choosing your product. Some product attributes are naturally consonant with certain sources of value.
  - For example, if your offering is the low-priced leader in the market, then it is especially likely to appeal to customers who seek monetary value.

  - But many product attributes can be communicated in ways that emphasize each of the sources of value. For example, a truck with a powerful engine can be positioned to appeal to those seeking functional, psychological, or social value.

- For a given product attribute, there is often a positioning decision to be made: How do you communicate the advantages of that attribute to the customer? To answer that question, you should know the source of value that is most likely to drive choice for your target customer. If it's social value, then communications emphasizing psychological benefits may fall flat. The key is to translate the value offered into the reasons the customer is likely to generate for his or her choice.

Key Marketing Questions

- We now have a clear definition of our topic: Marketing is the business function that creates value for customers and the company. With that definition in mind, we can begin to address some crucial marketing problems: How do you create a brand? How should you price a product or service? Where should you sell it—and to whom? What type of advertising should you use? What benefits should you communicate? This list of questions can quickly become overwhelming.

- But as we'll see over the course of the next several lectures, not all marketing problems are equal. Some are more important than others and must be solved first. To begin, then, let's identify the three key questions that you must answer before you address any others.
  - Who are your customers?

- What do they value?
- How can you give them what they value better than the competition?

- If you can answer those three questions, then you have the basis for a marketing strategy. And you must have a defined marketing strategy before you try to figure out the best tactics to use to accomplish it. In our first six lectures, we'll learn how to develop a marketing strategy by answering these three fundamental questions. In the second six, we'll investigate marketing tactics, addressing such issues as branding, pricing, and communication.

Suggested Reading

Chernev, *Strategic Marketing Management*, chapters 1–2.

Questions to Consider

1. Pick a product or service with which you are familiar and conduct a reason-based choice analysis of that offering. Consider the four potential sources of value a customer could get from that offering: functional, monetary, social, and psychological. What reasons might consumers have for choosing this offering over its competition in each of those four domains? How might that offering be improved by increasing one type of value?

2. Pick an attribute on which a product or service could differentiate itself (e.g., the most powerful engine in its class). Translate the benefits of that attribute into a reason in each of the four value domains: functional, monetary, social, and psychological.

How to Segment a Market

Lecture 50

We've already seen that the first question in developing a marketing strategy is: Who is the customer? Segmentation is how you begin to answer that question. In fact, segmentation is how you answer an even more basic question: Who are the possible customers you could serve? Segmentation is simply the process of grouping people together according to what makes them similar. To make this process as effective as possible, you should start with the universe of all potential customers for your product or service. In this lecture, we'll look at three approaches to segmentation analysis, each of which results in a list of customer segments with a rich description of their preference structures.

Principles of Segmentation Analysis

- The first principle of segmentation analysis is that there is no single "right" way to segment a market. Different brands can successfully segment exactly the same market in radically different ways.

- It's also important to understand that segmentation is not a one-time prospect. Markets are fluid. New customers come in, existing customers move out, competitors come and go and gain and lose market share. It is not enough to segment a market once and never return to it again. You should re-segment the market periodically; doing so is a great way to identify new opportunities or fix existing problems.

- When you conduct segmentation analysis, the segments should be both collectively exhaustive and mutually exclusive. In other words, everyone in the market should be in a segment, and each segment should be distinct and, to the extent possible, not overlap with any others.

- Perhaps the most important principle of segmentation is this: The segments you form should be based on what people value, not on differences in demographic characteristics, such as age, gender, geography, and so on. You will eventually create demographic profiles of your segments, but it is usually not helpful to start with demographics.
    - The idea of segmenting by value rather than demographics is counterintuitive. When you ask someone to divide potential customers into groups, it is only natural to start by putting men and women into different groups or putting people of different ages or incomes into different groups.

    - Further, marketers often provide descriptions of their target customers based on demographics. Such a description might read: "young men, ages 16 to 22, from upper-middle-class households, living in suburban neighborhoods, with moderate levels of disposable income."

    - That sounds like a specific target, but think of the diversity of identities, motivations, desires, and values contained within just that one fairly specific demographic segment. Those young men could be cool kids or outsiders, conformists or nonconformists, and so on. They certainly don't all want the same things, buy the same brands, or try to project the same image to the world.

    - Segmenting people by demographic descriptors alone will not tell you anything about the underlying values that drive their decision making. If you create segments based on surface differences only, you won't know what to do with the segments when you're done.

- The alternative to demographic profiling is to divide your market into psychographic segments, grouping people based on similarities in their psychological needs and desires.

Case Study in Psychographic Segmentation

- A major cable television provider found that its customers were unsubscribing and either switching to another provider or cutting off their cable service completely. To address this problem, the company decided to do a segmentation analysis to identify those customers who were most likely to defect and take steps to limit defections.

- The company used its extensive customer database to create several distinct customer groups and identified one group that was both particularly profitable and particularly likely to leave. The task, then, was to establish a plan to reduce defection rates in this group. Options included lowering prices for this group of customers, offering a discount on specific services, upgrading services in particular areas, and so on.

- But because this customer segment was created by looking at demographic similarities rather than value-based similarities, the company had no way of knowing which plan would work to retain customers. It knew that this group was in danger of defecting, but the segmentation didn't explain why the customers were leaving.

- Instead of segmenting by outward similarities, suppose the company had investigated the reasons people have for subscribing to cable in the first place. This approach might have identified different customer groups, such as Price Sensitives, Sports Junkies, Technology Lovers, and so on.

- This kind of segmentation is more difficult than demographic segmentation, often because it requires additional market research. But such a value-based psychographic segmentation is infinitely more useful than a demographic one.
    - For example, what if, after conducting psychographic segmentation, the company discovered that Technology Lovers were both especially profitable and especially likely to cancel their service?

- In that case, the company would have a clear path forward to retain these customers: Invest in new technology, introduce technological innovations, and trumpet technology in its advertising.

- Offering lower prices to this group probably wouldn't halt defections because these customers weren't leaving to seek a better price. It's even possible that lower prices could make these customers think that the company is a bargain-basement provider and cause them to leave even faster.

Approaches to Segmentation

- There are three approaches to conducting a segmentation analysis: user based, benefits based, and occasion based. Each of these approaches should lead to the same outcome: a mutually exclusive and collectively exhaustive set of customer segments, grouped based on similarities in their underlying values.

- A user-based analysis involves creating a list of the different types or classes of people who might use your product or service. For example, we could identify a number of groups of people who might use satellite phones: military personnel, international journalists, nongovernmental organizations (NGOs), international business travelers, and first responders.
    - The next step is to determine important features for each of these groups when they are considering a satellite phone purchase. Military personnel, for example, might value ruggedness and ease of repair in the field. International business travelers might be more focused on small size and ease of use.

    - The end result of this exercise should be a list of customer segments with a rich description of the preference structures for each group. The more detailed and specific you can get in describing what each group would want from the product or service, the better off you will be when it comes time to pick a target and position your offering.

- Once you have created a detailed list of segments, the next step is to see if any of the groups overlap in terms of what they value. If two groups want almost exactly the same features in an offering, you should probably combine them in one segment. You might also find that the initial user groups you defined should be broken into subsegments. For example, after further research, you might learn that different types of NGOs value different features in satellite phones.

- With the second approach to segmentation, benefits-based analysis, you start with the offering itself rather than the customers. Think of the different types of benefits a customer might derive from using your product or service, then determine the segments accordingly. Ask yourself: What benefits are most likely to drive a purchase in this category?
    - For example, consider the benefits of breakfast cereal: It's sweet, makes an inexpensive meal, is fast and easy to prepare, is heart healthy, and makes a great snack.

    - The next step is to determine which groups of people would appreciate each particular benefit. Families with school-aged children, for example, might appreciate the fact that cold cereal is fast and easy to prepare.

    - As with user-based segmentation, the end result of a benefits-based segmentation should be a list of customer segments with a rich description of preference structures.

- The third approach, occasion-based segmentation, differs from the other two in that it doesn't start with the premise that each person or household should be assigned to a different segment. Instead, it recognizes that the same person may have different needs depending on the occasion for using the offering. Thus, this approach starts by asking the question: When would consumers buy or use this product or service?

- For example, someone might buy wine to accompany a meal, to have on hand for a party, to give as a gift, for personal consumption in the evening, or to use in a religious ceremony. Unlike a user-based segmentation, any particular customer might fit into any or all of these occasion-based segments.

- After you have a list of occasions, the next step is to generate a list of the things people would value in the offering in each of those situations. For example, what features would someone look for in buying wine to accompany a meal versus to give as a gift?

- The difference among these three segmentation approaches—user based, benefits based, and occasion based—is in providing you with different places to start the process—different angles for looking at the same market. But all the approaches should lead to the same result: a list of customer segments that differ in their preference structures.

- Value-based segments are useful because they tell you what types of marketing actions will appeal to certain groups of people, but they don't help you identify and communicate with those people

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Knowing what their target segments value enables retailers to customize their stores to better serve these segments.

specifically. Thinking back to our cable company example, you wouldn't be able to distinguish a Technology Lover from a Sports Junkie in a crowd.

- For this reason, it is usually necessary to layer a demographic description on top of your value-based segments.

- Keep in mind, though, that it's still important to conduct psychographic segmentation first. It is much more useful to determine that a segment of customers values your product because it meets some specific set of needs than it is to determine the ages or addresses of your customers.

Suggested Reading

Chernev, *Strategic Marketing Management*, chapter 3.

Yankelovich and Meer, "Rediscovering Market Segmentation."

Questions to Consider

1. Choose a market for a particular product or service (such as flowers, rental cars, paper towels, or tax preparation) and try segmenting the market three times, using each of the three methods discussed in the lecture. Did each of the methods result in different segments, or were the segments largely the same? (Either is possible, depending on the market you select.) If your segmentation strategies resulted in different segments, is there a way to combine insights from these segmentation processes into a new segmentation of the market?

2. Choose a segment you identified in the previous exercise or one your employer currently serves. Develop an archetype of that segment—a rich description of a fictional character that embodies the segment's important psychographic and demographic characteristics. Create a mini–marketing plan for the segment. Where would you advertise to reach your archetype? Which sales pitches are likely to be most effective? Which competitors' products are members of this segment most likely to buy?

Targeting a Market Segment

Lecture 51

In the last lecture, we saw how to group potential customers into segments based on similarities in what they value. In this lecture, we'll discuss targeting, that is, deciding which of those segments you will serve and which ones you will not. Some companies use segmentation to identify all the groups of people they will sell to, then pursue all those groups with the same offering. But that approach is a little like separating your laundry, then throwing all your clothes in the washer at once. As we'll see in this lecture, to get the most out of segmentation, you must decide which groups are a good match for your offerings; otherwise, your marketing will fail.

Selecting a Single Target

- Targeting is the process of deciding which customer segments you will serve and which ones you will not. The key here is to recognize that by creating value for one segment, you will almost certainly make your offering less attractive to other segments. It's important to know who your customer is and—just as important—to know who your customer is not.

- For many businesspeople, it's difficult to face the fact that some potential customers exist who will not spend money to buy their products and services. That knowledge is painful; thus, these businesspeople are tempted to go after everyone, but that's a mistake.

- Unless you run a monopoly, such as a power company, your customer can't be everyone. You must pick a target and try to meet the specific needs of that segment. If you try to create something that will appeal to everyone, you will probably end up creating something that appeals to no one.
  - Suppose you've done a value-based segmentation analysis, and you've discovered that there are only two types of customers in a certain market: those that prefer blue and those that prefer red. As a manufacturer, you can choose to paint your offering

blue to target the blue customer group, or you can paint it red and appeal to the red customer group. But what if you paint your product purple and ask both groups to meet you halfway?

  - If you are a monopolist, that approach may work. Neither segment gets what it wants, but the customers have nowhere else to go. Both groups buy the purple option rather than go without, and you get all the customers.

  - However, if other manufacturers come along that are willing to provide offerings that are just red or just blue, your compromise solution will become a second-best option for all customers in the market. Without a specific target in mind, your competition will outflank you by providing each customer segment with something much closer to what it wants, and you will lose everyone.

- Of course, in the real world, customer segments aren't as easy to identify as blue lovers and red lovers, but the basic principle remains the same: You must have one target. Targeting is at least as much about defining who your customer is *not* as it is about deciding who your customer is.

- Even with products that are bought by one person but consumed by others, such as products for children, it's still important to identify one target. Consider, for example, brands of yogurt that seem to target both parents and children.
  - Horizon Organic brand yogurt seems to target children with a logo of a cartoon cow riding on a snowboard. But the copy on the packaging for this yogurt emphasizes the fact that it is organic and low fat and that no antibiotics, pesticides, or hormones were used in its manufacture. This is a yogurt that a particular segment of parents would love for their children to eat.

  - But if this offering is targeted to parents, why does the company use a cartoon cow for its logo? The answer is that part of the value that parents get from this yogurt is that their children will

eat it. In other words, targeting one group of customers—in this case, parents—does not mean ignoring the preferences of other groups involved in the acquisition and consumption of the offering.

- ○ Other yogurts for children also use cartoon characters on their packaging, but these characters are often from popular television shows. Such offerings are clearly targeted to those who tend to have strong attachments to cartoon characters—that is, children. However, many of these brands also emphasize that the yogurt is low fat or a good source of calcium to show that they aren't simply ignoring the concerns of parents.

- ○ Why don't we find an offering designed to appeal to both children and parents? Because it is usually one group or the other that drives the decision making in this category. A middle-of-the-road option would be outflanked by the yogurts targeted to children when children choose and by Horizon Organic when parents choose. By trying to target both groups, a manufacturer would probably miss both.

Making an Offering with Value

- One common mistake firms make is to target a segment just because that segment is attractive to the company. Perhaps members of a certain segment have a great deal of disposable income, or perhaps they're opinion leaders and could improve the brand's image if they start using the product. But the value that the customer provides to the company is only half of the equation. You also must consider whether the company is capable of creating an offering that the target customer actually wants.

- For example, in the early 1980s, the western-wear company Levi's conducted extensive research to re-segment its market and look for opportunities for growth. The results of the research showed that one small segment of the market accounted for a vastly disproportionate

share of spending on men's clothing. These "Classic Independents" loved to buy high-end clothes, particularly three-piece suits, and had somewhat conservative tastes.

- ○ Levi's reasoned that capturing just a portion of the money this segment spent on clothes would drive real revenue growth for the company. Thus, the firm developed a line of high-end suits in conservative cuts and colors. The quality of the suits was fine, but none of the accompanying marketing choices made by Levi's created any additional value for the Classic Independent segment.

- ○ The company sold the suits through retailers with which it already had a relationship, such as Sears, but of course, the Classic Independent segment would never go to Sears to buy a suit. Further, the suits were too expensive for the stores where they were sold but too inexpensive compared to what the Classic Independents usually paid for suits. Even the Levi's classic brand was a liability because it was not associated with high-end menswear.

- It is certainly necessary for a segment to be attractive to your company, but it's not sufficient. Customers in that segment must also find your offering attractive. In other words, you must be in a position to sell an offering that will create value for the segment you target. Both parties must come away from the transaction better off, or the transaction won't take place.

The Attribute-by-Segment Matrix

- A valuable tool to use in choosing a target is the attribute-by-segment matrix. To create this matrix, you must know three factors: the possible segments you could target, the attributes that are important in your product category, and the performance of your offering and the offerings of your competitors on those attributes. We'll construct a matrix using three offerings in the video game system market: Sony PlayStation (PS3), Microsoft Xbox, and Nintendo Wii.

Attributes	Customer Segments: Gamers	Customer Segments: Non-Gamers	Competitors/Company: Xbox	Competitors/Company: PS3	Competitors/Company: Wii
Cutting-edge graphics	H	L	H	H	L
Highly involved games	H	L	H	H	L
Complex storylines	H	L	H	H	L
High skill levels	H	L	H	H	L
Realistic graphics	H	L	H	H	L
Ease of interface	L	H	L	L	H

An attribute-by-segment matrix is a valuable tool for identifying targets that may be underserved by current offerings.

- To construct the matrix, first list the attributes that might be important for your product, framing each attribute in a positive way. For example, for a video gaming system, attributes might include cutting-edge graphics, highly involved games, complex storylines, realistic graphics, high skill levels, and ease of interface.

- The next step is to make columns for each of the customer segments. For our purposes, we'll consider only two broad segments: gamers (those who have played video games for years) and non-gamers (those who have much less experience with video games).

- We then determine how each of these segments would rate the importance of the attributes listed. For example, gamers would likely rate all of the attributes except ease of interface as highly important, while non-gamers would probably find cutting-edge graphics and complex storylines less important than ease of interface.
  - Note that in this listing, the gamers and non-gamers have completely different preference profiles: What's important to gamers tends to be less important to non-gamers and vice versa. But that may not always be the case.

  - Depending on how you construct your matrix, there may be certain attributes that are important to all segments and others that are important to none. But at the end of the process, you

should not have two or more segments that value exactly the same things across the board. If that's the case, then the two segments are probably the same and should be collapsed into one.

- Once you've mapped the attributes to customer values, the next step is to look at the performance of your company and that of your competitors. In our example, the Xbox and PlayStation systems perform high on all the attributes except ease of interface.
  - In the early 2000s, Nintendo looked at this competitive space and realized that it would be difficult to compete against PlayStation and Xbox if it went after the gamer segment. Gamers already had two strong options to choose from that seemed to match their preferences exactly. Thus, instead of directly competing against Microsoft and Sony, Nintendo chose to create an offering targeted to non-gamers: the Wii.

  - As a gaming system, the Wii was well behind other consoles on the attributes that mattered most to gamers, such as cutting-edge graphics and highly realistic play. But Nintendo focused its efforts on creating a simple and intuitive way of interacting with the game system, concentrating on the one attribute that was most important to non-gamers: ease of interface.

  - Many gamers scoffed at the Wii when it was first introduced, but Nintendo wasn't trying to create a game console that would appeal to that group. Instead, Nintendo chose a target that was not served well by Sony and Microsoft—a segment that included young children, older adults, and casual gamers who were mostly interested in family fun. And Nintendo customized its offering to serve that segment.

  - Nintendo succeeded by following the rules of targeting: Don't try to create a middle-of-the-road product designed to appeal to everyone. Instead, identify a target precisely and create a product that meets the specific needs of that target.

Suggested Reading

Chernev, *Strategic Marketing Management*, chapter 3.

Yankelovich and Meer, "Rediscovering Market Segmentation."

Questions to Consider

1. Choose a particular market about which you have some expertise or are willing to do some research. First, segment that market. (You can save some time by using the segmentation you developed in the assignments for the last lecture.) Then, construct an attribute-by-segment matrix. Start by generating a list of the attributes that might be important to different consumers and on which competitors might differentiate themselves. Next, rate the likely importance of each attribute to each customer segment. Finally, rate the offerings of the major competitors in the market based on how well they perform, in relative terms, on each of the attributes. Now, match the offerings to the segments. Do the offerings each map well onto a target segment? Are there any offerings that don't seem to fit with the needs of any particular segment?

2. Conduct a similar analysis of a particular market, but this time, instead of just looking to describe the current state of that market in an attribute-by-segment matrix, look for opportunities. If you were to introduce a new offering in this category, which segment would you target and why? Is there an incumbent brand that serves customers in a target segment but does not meet all their needs? Are there any segments that look as if they are not currently being served by any particular brands?

Positioning Your Offering

Lecture 52

According to what we might call the "better mousetrap" philosophy of business, customers should evaluate the offerings of various companies, then beat a path to the door of the firm that develops the best mousetrap. Many people believe that the business world should work in this way, with no puffery or spin from marketers. But in fact, it is more common for great products to fail, not because of the deceptions of marketers, but because the marketers themselves fail to communicate the true value of their offering. In this lecture, then, we'll look at positioning—the process of determining which aspects of an offering are most important in creating value for the customer, then clearly communicating that value.

The Positioning Process

- The positioning process involves two steps and two checks. First, we start by developing an offering's value proposition. Second, we select the one or two key benefits that anchor the positioning. The two checks that ensure the positioning achieves its objectives are: (1) Does the positioning create value for the target customer, and (2) does it differentiate the offering from the competition?

- The value proposition is an objective assessment of all the benefits of buying, owning, and consuming a product or service, written from the customer's perspective.
  - For example, the value proposition for Volvos in the 1980s might have included a number of benefits: a valued image for European imports over domestic cars, high performance, comfort, safety, reliability, and luxury.

  - In a better-mousetrap world, a marketer would simply communicate these benefits to customers and let them decide. This approach would seem to make a lot of sense. After all,

telling potential customers that a car is luxurious, safe, reliable, and exclusive should be more persuasive than telling them about just one of those attributes.

- But Volvo didn't take the approach of throwing the kitchen sink at its potential customers. Instead, it successfully implemented the second step in positioning, which was to choose just one key benefit to communicate to customers: safety. The main message of the cars' safety was delivered repeatedly in Volvo's advertising.

- Volvo was so successful in establishing the link between its brand and the safety attribute that this perception continues to this day, although Volvo no longer makes the safest cars on the road. How did Volvo create such an enduring impression in the minds of consumers? Instead of overwhelming customers with all the features that make a Volvo great, the company positioned the brand on its strongest attribute and created something that customers could understand and remember.

- In contrast, TiVo, the first company to market a digital video recorder (DVR), should have enjoyed a first-mover advantage when it introduced a radical technology that would fundamentally change the way people watched TV.
  - The value proposition for TiVo included such benefits as the ability to pause live TV, to watch a show on demand, to preschedule recording of selected shows, to skip ads, and to get recommendations about other shows customers might enjoy.

  - TiVo should have chosen the one benefit from that list that would most likely resonate with the company's target customer. But instead, the company opted to highlight all the potential benefits of the new technology, essentially delivering the message: TiVo can do everything.

- Despite being the first to market with a product that people loved, 14 months after launch, TiVo had only 42,000 subscribers. And before long, the competition swept in. As of 2012, TiVo had captured only about 4.5% of the DVR market. Being the first to build a better mousetrap was not enough.

- TiVo was eventually able to explain its complex message and educate consumers on the many virtues of the DVR. Unfortunately, by that time, many consumers were using their newfound knowledge on DVR systems they had purchased from other companies.

- It's important to remember that your value proposition is not your positioning. Don't tell your customer everything that is great about your offering all at once. Keep your message simple! Very rarely are consumers sufficiently motivated to process and understand complex messages. And when consumers don't appreciate how great your offering is, simply giving them more information is not the solution.

Creating Value for the Target Customer

- The first check on positioning is to ask: Does the positioning clarify the value that is being provided to the target customer? One way to think about positioning is as the flipside of targeting. After all, you can't hope to successfully position an offering without knowing for whom you are trying to position it. A given benefit will not create value for everyone. When choosing the one benefit you want to position on, look to your target customers. What do they value most?

- Imagine that you have been hired by a large American city to implement a bike-sharing program. To design this program, you need to make a number of decisions: Where will you place the terminals where people borrow or rent bikes? How much will you charge to rent bikes? What kind of bikes will you use? In short, how will you position your new bike-sharing program?

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Positioning a car around the benefit of safety works only if you are targeting a group of customers for whom safety is the primary driver of automobile purchase decisions, such as parents of young children.

- A good way to start would be to recognize that different groups of people want different features in a bike-sharing program; thus, it's important to identify the different potential targets for your program. A list of potential users might include commuters, people running errands, exercisers, and tourists.

- All of these groups would value convenience, but each group would find different locations convenient. Commuters would want locations close to both home and work, while those running errands would want spots near shopping hubs. Each of the groups might also prefer different kinds of bikes.

- The point here is that without knowing who your targets are, it is impossible to position your offering coherently. The dozens of decisions you must make in terms of what benefits to offer could either create or destroy value for your customer, depending on who your customer is.

- The mistakes of the SmartBike DC program in Washington, DC, launched in 2008, underline the lesson that positioning can make or break an offering.
    - Bike terminals in this program were placed in inconvenient and inappropriate locations; the bike designs were unattractive and impractical; restrictions were placed on check-out times; and users had to purchase an annual pass. In short, SmartBike was systematically positioned not to create value for any particular group of customers who might have had reason to use the bikes. The program was terminated two years after its launch.

    - Fortunately, a later program, Capital Bikeshare, corrected the mistakes of SmartBike and has been quite successful.

Differentiating from the Competition

- The second check on the positioning process is to ensure that you differentiate your offering from the competition. An important part of positioning a product is giving consumers points of parity with other offerings—that is, telling people what your product is like—and defining points of differentiation—that is, telling people why your offering is different from, and superior to, other offerings.

- To understand these ideas, let's look at advertising in the category of men's shower gels.
    - A commercial for Unilever's Axe shower gel identifies the product's competition as women's soaps. The commercial then defines the brand's point of differentiation relative to this competition: a masculine scent.

    - Similarly, in its commercials, Nivea for Men identifies its competition as Axe and its point of differentiation as a more subdued scent. The competition for Dove Men + Care is other men's body washes, and its difference is that it is clinically proven to fight skin dryness. Finally, Gillette identifies its competition as Dove Men + Care and its point of difference as its ability to fight odor.

- Note here the degree of variety in terms of positioning an offering. In just one relatively mundane category—men's body wash—different brands each chose unique attributes on which to position, and each chose a slightly different competitor or set of competitors against which to make its comparisons. Each brand defined its competition, then communicated the one way in which it was better than that competition.

- Note, too, that none of the men's body washes has positioned itself against bar soaps in general, although Axe defined its competition as women's soaps. It seems almost shocking that these brands all position themselves relative to the narrow category of body wash, when the larger soap category seems to hold so much opportunity for growth. Thus, the second lesson we can learn from this example is to think broadly when choosing your competition.

- One good way to articulate your positioning strategy is to craft a positioning statement: a single sentence that encapsulates everything that is important about the offering's position in the marketplace.
    - Positioning statements are not taglines or slogans. They are primarily for internal consumption—for keeping the marketing department (and, ideally, the company) focused and on message.

    - Positioning statements contain several important pieces of information: a brief description of the target customer, identification of the product category that serves as the competition (to establish points of parity), and a clear articulation of the primary benefit the offering presents to the customer relative to the competition (the point of differentiation).

Suggested Reading

Chernev, *Strategic Marketing Management*, chapter 4.

Gourville, "Eager Sellers and Stony Buyers."

Questions to Consider

1. Pick a product with which you are familiar. Develop a value proposition for that product—a list of all the benefits and costs associated with buying and owning it. Now pick one attribute you would use to position that product. How would your positioning change if you chose to target a different segment?

2. Pick a product category and watch as many commercials and read as many print advertisements as you can for competitors in that space. Determine how each of the competing brands has positioned itself. What are the points of parity each brand claims with its competitors? What are its points of differentiation? Who are its target customers?

Identifying Sources of Sales Growth

Lecture 53

In 1957, a mathematician and business strategist named Igor Ansoff published an article in the *Harvard Business Review* about the potential sources of sales growth. The focus of his article was diversification, a topic that we'll cover in this lecture. Almost as an aside, Ansoff proposed a framework for classifying different opportunities for sales growth. This two-by-two matrix, discussed in just a few paragraphs in an article that was primarily about something else, turned out to be one of the most powerful ideas in marketing. In this lecture, we'll look in detail at the Ansoff matrix, as well as another marketing tool, gap analysis.

The Ansoff Matrix

- The Ansoff matrix is a simple chart, as shown below. On the left side, customers are grouped into two categories: current customers and new customers. Across the top of the chart are two classes of offerings: current offerings and new offerings. The intersection of customer types and offerings creates four boxes that categorize opportunities for sales growth.

	Current Offerings	New Offerings
Current Customers	Market Penetration	Product Development
New Customers	Market Development	Diversification

- The first of these opportunities is market penetration, a situation in which a business sells its current customers more of its current offerings. Product development takes place when a business develops new products to sell to its current customer base. Market development encompasses sales of an existing product line to a new group of customers, and diversification includes sales of a new product line to a new group of customers.

- The Ansoff matrix lays out four sources of new sales and is a powerful tool for identifying new ways to grow your business.

Market Penetration

- Market penetration usually involves selling more of your current product line to your current customers. This strategy is typically the least risky means of increasing sales and, surprisingly, the avenue for growth that is most often overlooked by marketers seeking to increase sales. Selling a little more to people who have already indicated that they like your offering should usually be the approach you try first when looking for opportunities to increase sales.

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With casual Fridays, Levi's identified and exploited a cultural opportunity to sell more of its current product—Dockers—to current customers.

- One strategy for enticing your current customers to buy more of the offerings they already buy is to create additional occasions for them to use the product or service. Levi's Dockers brand used this strategy effectively in the early 1990s.
    - Dockers recognized the trend toward less casual business attire for men—especially the idea of "causal Fridays" at the office—as an opportunity for increasing sales. The company promoted and even shaped this trend through a pamphlet entitled "Guide to Casual Businesswear" that was mailed out to 25,000 human resource directors.

    - Most people who would wear Dockers to work once a week probably already owned Dockers for some other use, such as weekend outings with friends. By promoting casual Fridays, Dockers was not introducing its product to an entirely new group of customers. Instead, it provided current customers with a new opportunity to buy more of the current product line.

- Another example of a well-executed market penetration strategy comes from Arm & Hammer baking soda.
    - Baking soda is a commodity product, and historically, it was used almost exclusively for baking alone. If Arm & Hammer wanted to sell more of its product to its current customers, it faced the difficult task of trying to encourage more baking.

    - Instead, the marketers at Arm & Hammer leveraged the ability of baking soda to clean and deodorize and identified dozens of non-baking uses for the product, such as freshening the refrigerator, whitening clothes in the laundry, deodorizing the sink, and so on. The list of new reasons to use the product encouraged customers who probably already had some baking soda in their pantries to go out and buy more.

Product Development

- A product development strategy involves serving the same customer base with new products. The advantage of using this strategy is that you presumably already have a solid understanding of your customers and serve them well with some offerings. You then use that understanding to serve your customers through additional products or services.

- These new offerings don't necessarily have to be new to the marketplace, though they can be. Often, they are just new to your company. Many brand extensions are the result of following a product development strategy.

- Consider Kellogg's Special K brand of cereal. This product started as a low-calorie alternative to sugary breakfast cereals, but the brand now includes numerous other products, such as meal replacement bars, snack bars, frozen waffles, breakfast sandwiches, and more. All of these products are knit together under the aim of helping people—primarily women—manage weight. In this case, Kellogg's customer base stayed the same, but new products were added to the mix to better serve the customers.

- The fast-food giant McDonald's also executed a successful product development strategy with the introduction of salads to its menu.
    - In early 2003, McDonald's suffered its first-ever quarterly loss. Indeed, some store sales had been declining for 12 straight months. The strategies the company had implemented to turn sales around were not working. Some people thought the solution was for McDonald's to offer healthier food options, but the company hadn't had a successful new product launch in 20 years.

    - McDonald's solved its problem and pulled off a remarkable turnaround by looking for new ways to serve its existing customers. The company discovered that many parents who brought their children to the restaurants for a Happy Meal also ordered one for themselves. Further, McDonald's realized that these adult customers weren't being adequately served by the restaurants' offerings.

    - In response, McDonald's introduced a new line of "premium salads" specifically designed to serve customers who were already at the restaurants because of their children. After introducing this new option, the average Happy Meal order increased from about $5 to about $9. The "magic" here was not in introducing a salad but in knowing exactly who the customers were and what they valued.

Market Development

- Market development involves seeking out new customers for a current product line. Like product development, market development is typically more risky than market penetration. After all, you are going after a new group of customers, whom you probably don't know as well as your current customers. But the strength of a market development strategy is that you are not developing radically new products. Market development means selling essentially the same offerings to a new group of people.

- Geographic expansion is one of the more common means of market development. By opening a new store or office in a different location, you are seeking to sell the same products or services to customers who couldn't buy them before.

- Often, new customers can also be found by re-segmenting the market. New targets may then be chosen and small changes can be made to the product line, repositioning the existing offerings to serve new customers.
    - In an earlier lecture, we discussed Levi's pursuit of a diversification strategy in the 1980s, when the company tried to produce a new product—men's suits—for a new group of customers—the Classic Independents. As we saw, this strategy failed for Levi's; market development might have been a better approach.

    - At around the same time that Levi's was developing its suits, the market for casual jeans for women was largely untapped. It was actually Lee Jeans that is generally credited with having "discovered" this market. Levi's was trying so hard to find more exotic sources of growth that it missed a massive, low-risk opportunity it was perfectly positioned to grasp.

Diversification

- Diversification involves trying to sell a new product to a new group of customers. This is obviously the riskiest strategy because it involves two entirely new and different sources of uncertainty.

- The upside of diversification is that, when done correctly, it can vastly expand a company's reach. Ideally, serving different groups of customers, often in different markets, with a diverse set of products, often from different price/quality tiers, and sometimes in entirely different categories, can insulate a company from shocks or changes in any one market or product category. A diversified company tends to be a robust company.

- The range of hotel brands promoted by Marriott International is the end result of pursuing a diversification strategy. Each brand—from the lower-end Fairfield Inn & Suites by Marriott to the high-end JW Marriott Luxury Hotels—is distinctly positioned from the others to serve a different group of customers.

Gap Analysis

- Gap analysis is a tool used to diagnose the source of a sales failure. In other words, if you have a product or service on the market that is not selling, you perform a gap analysis to help determine why.

- One type of gap analysis is performed to manage adoption, or first-time sales. This analysis starts with the largest group of potential customers—your entire target segment. You then conduct market research to work through a series of potential impediments to sales and determine where the largest drop-offs are occurring. These are the gaps, and they tend to be where it is most worthwhile to address your efforts.
    - Impediments to adoption may include awareness, understanding, attractiveness, affordability, availability, and purchase intent.

    - It's important to conduct a gap analysis because each of these impediments requires a different solution. For example, an ad campaign designed to promote awareness must be different from a campaign to foster understanding. Find the gap before proceeding with a strategy.

- The other way to use a gap analysis is to examine repurchase. For many products, success is not measured simply by the number of people who buy the product for the first time but by the number who continue to buy it. For this kind of gap analysis, you start with purchase. In other words, the largest possible category is people who have bought at least once. You then look at impediments to repeat purchasing, which include satisfaction, usage frequency, usage quantity, and repurchase intent.

Suggested Reading

Chernev, *Strategic Marketing Management*, chapters 14–15.

Ansoff, "Strategies for Diversification."

Questions to Consider

1. Use the Ansoff matrix to explore some opportunities for sales growth. Pick one company in a market you are familiar with or that you would like to become familiar with. Prepare a detailed strategy to increase sales using each of the four categories identified by Ansoff: market penetration, market development, product development, and diversification. Consider the potential risks and rewards of each of your solutions.

2. Perform a gap analysis on a product you are familiar with. In lieu of conducting actual market research, use your intuition and make some educated guesses about which impediments are probably most significant in limiting both purchase and repurchase.

Deriving Value from Your Customers

Lecture 54

As we've seen in earlier lectures, both the customer and the company must get something out of an exchange in order for it to be considered a success. In the last lecture, for instance, we talked about the direct value customers can provide to companies in the form of sales. But in this lecture, we'll think more broadly about other sources of value a company should seek. In particular, we'll cover three additional kinds of value that customers can create for companies: loyalty value, information value, and communication value.

Loyalty Value

- Customer loyalty is seen as a kind of philosopher's stone by some people in marketing. Loyal customers are widely considered to cost less to serve and to be less price sensitive. They tend to buy more and make purchases more often. They are also more likely to forgive a company when it makes mistakes and to serve as brand ambassadors. But the fact is that many of the purported benefits of customer loyalty haven't held up to empirical scrutiny. The link between loyalty and its assumed benefits has often been difficult to pin down.

- A part of the problem for researchers investigating loyalty is that it is often operationalized in purely behavioral terms.
    - Combing through your database, you might consider a customer to be loyal if he or she has bought more than a certain amount of your product within a certain time frame. Or if you have retailer-level data, you might look at the people who buy an especially high proportion of one brand relative to others in a particular category.

- To be sure, you might generally expect a loyal customer to buy more of your offering, but frequency, volume, and share of purchase are not necessarily evidence of loyalty. It could be that someone buys from you out of habit. Behaviorally, habitual buying would look similar to loyalty, but psychologically, the two behaviors are very different.

- Habits tend to be unthinking, unconsidered behaviors triggered by external environmental stimuli. Perhaps entering the snack-food aisle at the grocery store serves as a cue for you to buy Triscuits. Loyal customers, in contrast, are more likely to view an exchange with a company through the lens of a relationship. They deliberately choose to buy an offering because they like it.

- In the normal course of events, habit and loyalty might look the same. But if something changes to interrupt the cues—a store rearranges its shelves or a customer moves to a new city and faces new environmental cues—then the habitual behavior is never triggered. Loyalty is more robust than habit. It is rooted in a feeling that one offering is somehow superior to others. Obviously, the differences in these types of behavior can be significant for your business.

- For companies that are interested in fostering loyalty among their customers, using the behavioral indicators found in their purchase databases may not be the best place to start. Susan Fournier, a marketing researcher from Boston University, is among a growing group of scholars who study loyalty using the tools provided by sociology and anthropology instead of those provided by statistics and economics.
  - By spending time with individual consumers and listening to them talk about brands at length, these researchers have discovered that customers use different language in discussing the brands to which they are loyal. Specifically, loyal customers talk about brands as relationship partners.

- The nature of these relationships is important because it affects how customers think about their exchanges with the company. The anthropologist Alan Fiske noted that people form different kinds of relationships and that these different relationship types color the way we engage in economic transactions.

- For example, a market pricing or market exchange relationship is focused on maximizing economic value. This might be the type of relationship you would have in the sale of a car to a salesperson at a used-car dealership. In contrast, a communal sharing relationship is focused on maximizing fairness. You might have this type of relationship in the sale of a car to a friend or a relative.

- The types of relationships people form with others have parallels in the relationships people form with brands and companies, and many of those brand relationships are based on market exchange. We recognize the company as an entity out to maximize its utility, and we enter the exchange seeking the same. But some of the exchanges we have with companies or brands seem based to a greater extent on communal sharing. Consider, for example, people who are loyal to Apple products and tend to blame any computer problems they have on software rather than the Apple hardware.

- For all these reasons, it is important to distinguish between loyalty and its purely behavioral equivalents. In particular, think about "loyalty" programs at many companies. These programs incentivize repeat purchases, and many are successful at doing so, but are they really generating loyalty? Would people continue to buy if the "loyalty" rewards were eliminated?
  - Of course, customer incentive programs can be powerful tools to drive sales, but managers should not fool themselves into thinking they relate to loyalty.

- Loyalty is different than incentivized sales; it is a potential source of value for companies, and they should give careful consideration to how much it is worth to cultivate a more loyal customer base.

Information Value

- As many smart companies know, customers can provide you with vast amounts of valuable information. For example, simply by collecting aggregate and, increasingly, individualized data on customer purchases, companies can get personal health information on customers. This information can be used to customize offerings, develop new offerings, and make more accurate forecasts.

- The information you can collect is not limited to sales data. Requests for information or navigation patterns through your website or physical stores can also teach you something about your customers. Such information should be considered as a potential source of value customers can provide—in addition to the money they give you in an exchange.

- Further, customers can give you valuable information about your own operations and marketing. A complaint from a customer may highlight process failures, communication failures, or inadequate company policies and procedures. It's a good idea to assume that every customer bringing you information—both positive and negative—is speaking on behalf of several others.

- In many cases, you can hire a consultant to audit your processes and procedures and give you good insights about how to improve them. But you may also be able to get many of these insights for free by simply listening to your customers—both the happy and the unhappy ones. In other words, use your customers as consultants.
  - One company that uses its customers in this way is Stew Leonard's, a small chain grocery store and dairy in the northeastern United States. Although the stores have a relatively small inventory compared to typical grocery stores,

the chain has been called the "Disneyland of dairy stores." Costumed entertainers greet children in the aisles, and some locations even feature petting zoos.

- ○ But what truly makes Stew Leonard's unique is the process the store uses to find the ideas it implements on the sales floor. Every store contains an oversized suggestion box, which customers fill every business day. And every morning, a staffer is assigned to type up the suggestions and circulate them to the various departments around the store. Before lunch, every member of the staff has a list of positive and negative feedback items provided by customers. The company also holds regular focus groups with customers.

- ○ How well has this philosophy of listening to the customer served Stew Leonard's? The chain is in the *Guinness Book of World Records* as having "the greatest sales per unit area of any single food store in the United States." It has also enjoyed a consistent spot on Forbes's list of the top 100 employers in the country.

Communication Value

- Communication value is the value that customers bring to a company by talking to other potential customers about the business—in other words, customer word of mouth. Communication value stands in contrast to the other types of value we've discussed because it is often concerned with negative value.

- The communication value of customers is difficult to account for because it is difficult to measure directly. But even though it is hard to know exactly how much word of mouth affects your customers, it is relatively easy to determine, in general terms, how important word of mouth is likely to be to your company. You can start by asking yourself some general questions about the type of market you compete in and the type of customers you serve.

- ○ When determining how important communication value is to your company, you should first determine the structure of the market in which you are competing. Is it a competitive market, one with many alternatives for customers to choose among? If it is, then the opinions of consumers—both good and bad—are likely to have a significant revenue impact.

- ○ You should also look at the types of goods or services you sell. People are more likely to talk about some types of purchases with their friends than others. For example, most people do research when considering big-ticket items, and that research may involve asking other people their opinions. Likewise, goods and services whose quality is difficult to assess beforehand, such as the work of doctors, mechanics, and contractors, are especially susceptible to the effects of word-of-mouth communications.

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If you sell to teenagers, then you probably have many customers with large social networks and should be aware of the influence of customer word of mouth.

- ○ Next, ask yourself about the customers you serve. Some customers are especially likely to influence others with their opinions, such as those who have large social networks, are leaders in their communities, or are skilled communicators. Even if your target market doesn't seem to contain a disproportionate share of influencers, you should still consider the size of your overall target segments. In a large enough group of customers, some of them will have the skills and motivation to influence others.

- Finally, ask yourself about the types of experiences your customers are likely to have with your offerings—both the good experiences and the bad. How typical are those experiences? How easy is it for others to identify and sympathize with the customer who had an especially good or bad experience?

Suggested Reading

Agarwal and Larrick, "When Consumers Care about Being Treated Fairly."

Chernev, *Strategic Marketing Management*, chapter 5.

Fournier and Yao, "A Case for Loyalty."

Questions to Consider

1. Consider the differences between loyalty and habit. Keeping in mind that these two customer characteristics are often indistinguishable using purchase data alone, how would you measure loyalty? What tactics would you use to increase customer loyalty? In order to make this exercise concrete, pick a specific product or service with which you are familiar and define a specific target segment whose values you understand. What could you do to increase the loyalty of this group for this particular offering? How would you know if you were successful in increasing loyalty?

2. Give some thought to the information value of customers. Consider your company (or a company with which you are familiar) and generate a list of concrete ways that company could make better use of the information its customers provide. Think both of information about the customers themselves (e.g., through purchase histories) and information about the company (e.g., through complaints). How might this information be collected more efficiently? How might it be analyzed in a timely manner? What kinds of questions might this information answer?

Creating Great Customer Experiences

Lecture 55

Up to this point, we have focused on marketing strategy. In particular, we've looked at answering three all-important marketing questions: Who are your customers? What do they value? How can you give customers what they value better than the competition? We answer those questions through the process of segmentation, targeting, and positioning and by accounting for the various sources of value that customers and companies get from an interaction. These are all strategic concerns, and as we've said, strategy must come first. But once you have a strategy, you must successfully implement it; this is the topic we will discuss for the remainder of these lectures: the marketing tactics you can use to implement your marketing strategy.

The 4 Ps and the Marketing Mix

- The most famous framework for remembering all the marketing tactics you have at your disposal is the 4 Ps: product, price, promotion, and place.
  - *Product* refers to the offering itself—the attributes of your product or service. In this context, *product* includes such elements as branding, packaging, and warranties.
  - *Price* is fairly straightforward, but again, in this context, it also includes temporary discounts, such as sales and coupons, and nonmonetary costs to the consumer, such as time, energy, and attention required to buy the product.
  - *Promotion* refers to all non-price factors involved in incentivizing a purchase, such as advertising, sponsorships, salespeople, and so on.
  - *Place* refers to distribution. How does the product get to the customer? Where can the customer buy the offering? *Place* includes virtual locations, such as websites.

- The 4 Ps were developed as a tactical framework by marketing professor Edmund McCarthy in 1960 and have served marketers remarkably well since that time. However, you should keep in mind two words of warning about the 4 Ps:
    - First, because of its popularity and history, some people have come to treat the 4 Ps as if the framework encompasses everything we need to know to solve marketing problems. That's not true! Always remember that the 4 Ps is a tactical framework. You need a strategy before you can hope to use the 4 Ps well.

    - The second danger in using the 4 Ps is remembering that this framework also includes everything behind the four P-words. To use the 4 Ps correctly, it's not enough to remember what the Ps stand for. You must also remember all the non-Ps that are included in the four broad categories of product, price, promotion, and place.

- A slightly expanded tactical model is based on the marketing mix framework developed by Alexander Chernev in his book *Strategic Marketing Management*. This framework includes seven basic classes of decisions that marketers must make about their offerings: product, service, brand, price, promotions, communication, and distribution. Taken together, these seven variables are referred to as the *marketing mix*.

The Customer Experience

- There are a few approaches to making tactical decisions about products and services. One that has become popular involves designing products and services to provide the best possible experience for the customer. The basic idea is that customers' evaluations of products and services are actually evaluations of their experiences with the offerings—how it feels to buy, use, and consume them.

- Products and services are different in some important ways; products tend to be tangible and separable from production, for example, while services tend to be intangible and "consumed" at the same time they are created. But focusing on the customer experience blurs those differences. From a customer experience standpoint, what matters isn't whether the offering is a product or a service but what the customer thinks and feels during the interaction. In essence, the focus on customer experience means treating every offering as if it were a service.

- To design products and services around the customer experience, it's important to understand how people evaluate experiences. Consider, for example, your last vacation. A vacation is made up of thousands of individual moments in time, but when it's over, you somehow end up with an aggregate impression of the entire trip. How did you aggregate all those individual moments?
    - Researchers have determined that there are two points in time that overwhelmingly determine how we evaluate an experience, whether it's a phone call with customer service, dinner at a restaurant, or a trip to Disney World.

    - The first point is the peak, that is, the best, most enjoyable point of a good experience or the worst, least enjoyable point of a bad experience. The other point in time that matters is the end—what you were feeling as the experience came to a close.

    - When people look back on an experience and rate how they felt about it—what psychologists call *retrospective evaluation*—a simple average of the peak and the end predicts how they will rate the experience as a whole.

    - This finding is so robust that it has come to be known as the *peak-end rule*, and it leads to several specific bits of advice for managing customer experiences.

Rules for Managing Customer Experiences

- The first rule for managing customer experiences is to finish well—or at least less badly. Because the end is one of the two points in time that matter the most, you want to make sure that it's great. Or if you can anticipate that the experience will be unpleasant for your customer—a call with your service center to report a problem, for example—do what you can to make sure that the end of the experience is as good as you can reasonably make it.

- The second rule is related to the first: Get bad experiences out of the way early. If there is any part of the interaction with a customer that you know will be unpleasant, getting it out of the way early reduces the likelihood that the worst part of the experience will come at the end.
  - For example, many firms acquire business by pitching their services to prospective clients. And in many of these sales-pitch meetings, the team explains all the benefits of the service upfront and ends the meeting by revealing the price.

  - But think about this approach from a customer experience standpoint: Most of the good information is communicated in the beginning, and the price—which is usually the client's least favorite part of the meeting—is saved for the end. The peak-end rule suggests that clients may remember the experience of the pitch meeting more favorably overall if the least pleasant part were to come earlier in the meeting.

- The third rule for managing customer experience is to focus on the peaks. If you are considering two ways of improving your customer experience—one that will improve the average throughout the experience and one that will make the best part just a little bit better—you should choose the second. Improving the peak is more likely to deliver an overall improvement in the customer experience.

- The fourth rule here is to consider the reference points. Experience evaluations are often made relative to some reference point—some expectation of how the experience should go. Your job as a marketer is to determine what reference points your customer is likely to have when evaluating your experience and, when possible, to influence your customers' judgments by providing those reference points.
  - One reference point that marketers can control is that established by the company's own communications. If advertising, social media campaigns, and public relations messaging all paint a picture of a magical experience, customers will take note and set their expectations accordingly.
  - Customers differ in terms of the expectations they bring to market transactions. Therefore, one way of tackling the tricky question of customer reference points is to treat it as a segmentation and targeting problem. Are the customers

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Recognize the level of service your customers are likely to expect based on the category in which you are competing.

you seek to serve especially discerning or well informed? Then, they are likely to have high expectations, and you should plan accordingly if you want to provide a great customer experience.

- ○ Another place to look for help in determining what your consumers may use as reference points is the category in which you are competing. Customers tend to evaluate experiences relative to the environment in which they find themselves. Some categories have a reputation for high product quality or high levels of service, and customers will tend to expect more.

- ○ A final bit of advice on using customer reference points to anticipate customer experience is that reference points reset. People tend to acclimate to what they have previously experienced, and what was outstanding yesterday becomes the minimum standard today.

- The fifth rule for managing customer experience is to segment pleasures and combine pain.
  - ○ People tend to evaluate discrete experiences individually; thus, when designing products and services, you should seek opportunities to let your customers feel as many discrete happy experiences as you can. For example, have your salespeople introduce and demonstrate each benefit of the equipment you're selling one at a time, allowing potential customers to absorb the information in discrete experiences.

  - ○ The opposite advice holds for bad experiences: Combine pains. If you need to call a customer to explain a delay or a recall, make sure to convey all the possible bad news at one time. If you dribble out bad news over time, each new disappointment will be felt as a fresh injury.

- The last rule for managing customer experiences is to motivate and empower employees who will interact with your customers.

- On the incentives front, make sure that employees are evaluated on, and rewarded for, providing good customer experiences. This may mean developing employee evaluation tools that incorporate customer feedback as a metric. It may also mean tracking, praising, and publishing internally examples of great customer service. Make providing great customer experiences a source of prestige within the organization.

- Once a culture of customer service is established, employees will internalize that motivation. It will become an intrinsic part of how your employees interact with customers all the time.

Suggested Reading

Chernev, *Strategic Marketing Management*, chapter 8.

Questions to Consider

1. Think about some recent purchases you have made and categorize them as products, services, or some mix of both. Think about how you could improve the customer experience associated with that offering. In particular, are there any ways you might treat the products more like services by focusing on the customer experience?

2. Pick a product or service with which you are familiar. Is there a way to use the principles of reference points, the peak-end rule, and segmenting pleasures and combining pains to improve the customer experience?

The Tactics of Successful Branding

Lecture 56

Branding your offering is an important tactic, but it's vital to keep in mind that branding is only a tactic, and decisions about it should be attempted only after you have a strategy in place. In other words, you should not try to settle on any aspect of your brand until after you know who your customers are, what they value, and how you plan to position the offering so that it will provide superior value relative to your competitors. In this lecture, we'll define branding and look at how brands provide value to the customer.

Defining a Brand

- One definition of a brand is practical and focuses on the branding elements associated with a particular product or line of products. Branding elements include some concrete features, such as the product name, logo, slogan or tagline, a character or spokesperson, packaging design, endorsements, sponsorships, and so on. Branding elements can also include more abstract components, such as a design aesthetic or guiding philosophy.
  - This definition of a brand takes the company's perspective. Many companies have detailed rules about what can be done with branding elements, including acceptable color schemes and moderations that may be made to logos.
  - This is a useful way of defining a brand, and every company should know—internally—what elements are part of its brand.
- But this internally focused definition of a brand is not sufficient. We must also consider what a brand is from the customer's perspective. Here, we can think of a brand as made up of structures in memory, similar to a network with many individual nodes and connections.
  - The nodes in this network are memories—feelings, information, experiences, thoughts, and evaluations—that are associated with the brand.

- The nodes closer to the center are those that are more tightly bound to the brand. Those farther out on the edges are memories that are less integral and more transient.

- This definition of a brand as a memory structure makes it clear that managing a brand is really about managing the associations consumers store in memory related to that brand. Thus, establishing a brand goes beyond just choosing a clever tagline. It means being consistent and reinforcing important ideas repeatedly.

Case Studies in Branding

- Over the past several years, the office supply brand Staples has sought to establish the idea of low prices in the memory structures of its customers. Unfortunately, the "Easy Button" campaign run by Staples earlier has been more long-lasting in the minds of customers and seems incompatible with the idea of low prices.
    - The positioning of Staples as the place to go to quickly solve office supply problems was a good choice in the crowded office supply retailer space. The "Easy Button" campaign conveyed a simple message that provided a distinct source of value to a particular group of customers.

    - The problem arose when Staples tried to position both on being easy—which suggests a high level of service and convenience—and on having low prices. These ideas are in conflict for most people.

    - To the extent that Staples was successful in establishing a node in memory linking the store to "easy," it also probably inhibited the link between Staples and "low prices." By the same token, if Staples is eventually successful in establishing a memory structure linking the store to low prices, it may do so at the expense of the easy message. Some links in memory inhibit others.

- Staples has also promoted its brand by sponsoring the Staples Center, the basketball arena of the Los Angeles Lakers. This sponsorship certainly gets the brand a great deal of attention, but again, customers may associate the Lakers with glitz and glamour, and these associations are inconsistent with the low-price message.

- The Staples case highlights two lessons: (1) Be consistent, and (2) when you encourage consumers to form an association with your brand, make sure the association is something they value.

- NESCAFÉ, the first brand of instant coffee, serves as another example of mistaken branding. When the product was first introduced in the 1940s, it was advertised as a way for "housewives" to take a break from their demanding chores and treat themselves during the day. Unfortunately, women in the target market didn't associate the brand with relaxation but with slacking off.
  - A research study published in 1950 showed that housewives characterized women who bought NESCAFÉ as lazy, poor planners, spendthrifts, and even bad wives!

  - NESCAFÉ was successful in creating the mental associations it had set out to create, but those were not the associations that appealed to its target customers.

- When making branding decisions, keep in mind that you are trying to manage the associations consumers form with your brand. Try to reinforce those associations you want them to have and inhibit those associations you don't want them to have.

Branding and Customer Value

- In an earlier lecture, we discussed the four sources of value for customers: functional, monetary, social, and psychological. Functional value is accrued by virtue of an offering doing what it was designed to do. Brands contribute to consumer evaluations of

functional value by serving as signals. In economics, *signal* refers to an easily observable but unimportant attribute that serves as a proxy for a difficult-to-observe but important attribute.

 - If you are buying a car, you want reliability, but that quality is difficult to observe directly before purchase. Instead, we tend to use brand as a signal of reliability because brand is an easy-to-identify attribute.

 - We know that Honda, for example, is a brand that tends to be correlated with high reliability. Thus, brands influence functional value by providing signals.

- Monetary value can also be influenced by branding. A brand sets a reference frame for consumers when evaluating prices. If you were to hear about a Bic pen selling for $50, you would probably be shocked by the price. But if you heard about a Mont Blanc pen selling for $50, the price might seem like a bargain. Even though you don't know anything about the pen other than the brand name, the brand alone influences your evaluation of prices, thereby affecting the monetary value you derive from the offering.

- How can you ensure that your brand serves as a signal to boost functional value or as a reference frame to boost monetary value for your customers?
  - Both of these sources of brand value are based on correlations in the minds of consumers: When your brand consistently produces high-quality offerings or offers consistently low prices, those links are reinforced in memory, and your brand's signal value is improved. But if you are not disciplined and consistent with managing the brand associations your consumers form, your brand's signal value will be much weaker.

  - In short, your brand must stand for something. And the way to make that happen is the slow, regular, repetitive communication of a consistent message.

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If you've ever bonded with someone over the sports team you both love, then you've experienced the social value of brands.

- For social and psychological value, brands don't serve as signals of, or reference points for, another source of value. Instead, the brands themselves create value for customers. Brands provide social value by facilitating relationships with other people. In many situations, the brand can serve as a kind of passkey that lets you into a clique or group, as the brand Harley-Davidson does for owners of those motorcycles. Brands can also provide an excuse to talk to someone or serve as a topic for conversation.

- Brands can provide two types of psychological value: (1) internal, affecting how we feel about ourselves, and (2) external, affecting how we define ourselves to the world and influence others' perceptions of us. Often, psychological brand value is referred to as *lifestyle branding*; brands that provide psychological value define a lifestyle we are attempting to create and communicate to others.
    - Again, the Harley-Davidson brand provides internal psychological value to its customers by allowing them to adopt a "tough guy" image. People who ride Harleys and wear Harley jackets feel something different about themselves; they actually become someone else temporarily by associating themselves with a brand.

- ○ The Harley-Davidson brand also provides external psychological value. Some people use the brand to communicate something about themselves—perhaps a "wild side"—to others.

The Branding Ladder

- There is a common belief among marketing managers that it is better to build a brand around psychological value than around functional value. In fact, the sources of value are sometimes ordered from the most concrete—functional value—through monetary and social value, up to the most abstract value—psychological value. This concept is known as the *branding ladder*.

- It is not difficult to think of successful brands that started as functional brands but have moved up the ladder over time. Puma, Swatch, Timberland, Patagonia, and Nike all initially positioned themselves in terms of functional superiority relative to competitors but, over time, moved into a space where they could serve as a source of psychological value for customers.

- It is also easy to see why marketing managers view moving up the ladder as a good thing. Functional attributes are more concrete and, thus, more open to blatant attacks, while more abstract social or psychological values are usually harder to make substantive claims against. But it's important to note that lifestyle brands are not as unassailable as they might seem.
  - ○ To understand the potential downside of building a lifestyle brand, we first have to understand why consumers would value a brand that provides psychological value. The answer is that lifestyle brands, just like other kinds of brands, create value by meeting a consumer need. In the case of lifestyle brands, that need is for self-expression.

  - ○ However, the need for self-expression fluctuates over time and can be fulfilled in many ways. Customers can self-express through brands but also through politics, hobbies, and so on. Further, the need to self-express is not limited to a particular product category. You do not have one need to self-express

through your car, a separate need to self-express through your clothing, and so on. The need to self-express is a single, unitary need that can be sated in any number of different ways.

- Taken together, these three insights suggest that there are some dangers to lifestyle branding. When moving away from a functional positioning for your brand, you allow yourself to serve a more fundamental consumer need, but you also open yourself up to cross-category competition from any other brand that is trying to serve the same need. You are no longer just fighting for a share of the sales in a particular category but a share of the consumer's identity.

Suggested Reading

Chernev, *Strategic Marketing Management*, chapter 9.

Chernev, Hamilton, and Gal, "Competing for a Consumer's Identity."

Haire, "Projective Techniques in Marketing Research."

Questions to Consider

1. Pick a brand that you like and list all the brand elements you can identify—the logo, taglines, color palettes, spokesperson or character, packaging design, and so on. Try to determine which elements are most central to the brand. Which elements could be changed without affecting how consumers thought about the brand?

2. Pick a brand (the same brand or a different one) and list all the associations you have with it. Give yourself several minutes to free associate. What memories, feelings, experiences, or people come to mind when you think of this brand? Once you have created a long list, go back through and rate each item in terms of how central it is to the brand. Usually, the things you thought of first will be those you consider most strongly associated with the brand. This rated list serves as a representation of your memory structure of the brand.

Customer-Focused Pricing

Lecture 57

One of the most important decisions you will make in marketing is how to price your product or service. Pricing is a tactic, however, and like all other tactics, should not be decided until after you have settled on a strategy. In other words, you should not attempt to price your offering until after you know who your customers are, the specific sources of value you seek to provide to those customers, and how your offering will be differentiated from the competition. Assuming that you've addressed these basic strategic questions, you can turn to the tactic of pricing. In this lecture, we'll look at several considerations related to pricing products and services.

Pricing Information

- You need three basic types of information to set a price that will jointly maximize value for both you and your customer. The first piece of information is internal: What are the costs associated with making and selling the offering? Cost information is important because unless you have carefully tracked your costs, you could end up accidentally selling your product at a loss.

- Even though cost information is important, when you consider everything that goes into smart pricing decisions, costs are actually among the least important bits of information you need. Cost information sets a floor on what prices are possible for your firm, but costs tell you nothing about how your customer will evaluate your prices. Thus, the second type of information you need to price your offering is your competitors' prices.
    - Keep in mind that the relative importance of competitors' prices depends on the type of market you are in and the type of product or service you sell. If you are in a market with many competitors and it's easy for your customers to compare prices,

then keeping up with your competitors' prices is extremely important because your customer will almost certainly use that information to evaluate your price.

  - In contrast, if you are in an industry in which comparisons are difficult or offerings are highly differentiated, then up-to-the-minute tracking of competitors' prices is less important in determining your pricing strategy.

  - When analyzing your competitors' prices, you also need to make sure that you use the right set of competitors. Your competitive set should not be determined by any kind of market designation, such as subcompact cars or liquid hand soaps. It should not simply be the other brands in your category as defined by major retailers or distributors.

  - Instead, your competitive set should always be defined by your customers. What other options will your customers use for comparison when they are considering your product? If there are certain brands in the same category that your customers would never consider buying, then those brands are not in your competitive set, and their prices are irrelevant. This also means that your competitive set could span traditional category markers if your customers consider options across categories to be substitutes.

- The third and most important type of information to consider when setting your price is the value your customers place on your offering. Costs and competitors' prices are important to know, but ultimately, your goal is to price your products in such a way that your customer thinks that what you are selling is worth what you are asking for it. The most important lesson in pricing, then, is to know who your customers are and to price according to the value they see in your offering.

Pricing Variations

- At times, you may have more than one target group of customers, and those groups may value your offering differently. What do you do if one group is willing to pay $2 for your widget and another is willing to pay only $1? If you want to sell to both groups, do you have to set the price at $1 and leave the potential for extra money on the table?
    - Sometimes, the answer to this question is yes; you have to lose out on that extra potential profit. But sometimes, it is possible to identify barriers in the marketplace that differentiate target customers according to when, where, or how they buy.

    - Once you have identified those barriers, it is often possible to charge two groups different prices for the same or substantially similar products. This practice of charging different prices to different groups is known as *price discrimination*.

- When price discrimination occurs over time, it is sometimes called *price skimming*. Electronics companies frequently engage in this practice. They know that there is a small group of customers who want to be the first to have the latest technology. Thus, electronics firms charge this group of early adopters a premium for getting a new gadget first; they then slowly drop the price over time to appeal to those who would like a bigger TV or a faster computer but are not willing to pay a higher price to get it first.

Competing on Price

- Given the importance of price in driving consumer decision making, firms often have a strong inclination to lower prices, but there are several dangers associated with competing on price, including the risk of inciting a price war.
    - Some people seem to believe that there exists some magic price point at which your price will be sufficiently lower than your competitors' prices that your customers will notice and choose your product but not so low that your competitors will react and lower their prices. The fact is that this magic price does not exist. If your lower price drives customers away from

    your competitor to you, your competitor will react. And often, the fastest, easiest response is to simply lower prices to match your price drop.

    - The only way to win a price war is if you have the lowest cost structure in your competitive set. If you do, you can sustain lower costs over the long haul. But if you don't have significant cost advantages, then trying to win on price is a losing proposition. Try differentiating your product, focusing on branding, or changing your distribution, but don't compete on price unless you have an advantage on cost.

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Essentially, when you lower prices to attract customers, you are paying customers to buy your product.

- One of the justifications for lowering prices is to attract new customers, but this represents the second danger of low prices: If you must lower your prices to attract customers, you are probably failing somewhere else in your marketing. You may not have done your targeting and positioning correctly.
    - The experience of companies who used Groupons underlines this point. With the Groupon service, customers sign up to get periodic offers for significant discounts on restaurants, spa treatments, and so on.

    - Initially, many companies jumped at the chance to offer Groupons and get new customers to try their products. But they soon discovered that once customers took advantage of the discounts, they never came back.

- The last danger of pricing low is the inferences customers make about quality based on price. The fact that people tend to associate lower-priced options with lower quality is well known, but not

many marketers realize just how powerful this tendency can be. Research has shown that knowing the price of an energy drink can influence how people rate a workout after consuming the drink and even how well they perform on mental tasks.

- It's also important to note that customers are often not nearly as well informed about prices as many marketers assume they are.
  - In one groundbreaking study, researchers asked shoppers in a grocery store the prices of products they had just placed in their baskets. Remarkably, even immediately after placing an item in their carts, fewer than half the shoppers were able to report an even somewhat accurate guess about its price.

  - Some people have interpreted these results to mean that price doesn't matter—that consumers don't pay attention to, or care about, price. That's probably not true, but there is reason to question the assumption that consumers are always well informed about prices.

Evaluating Prices

- Customers have two alternative paths for evaluating prices, the first of which is to compare the prices of related items. For example, customers may not know exactly how much a blender should cost, but by comparing the prices of all the blenders on the shelf, they can form an idea about whether the price of a certain blender is attractive or not. This is known as using external reference prices or the local context to evaluate prices.
  - In managing context-based price comparisons, marketers need to be aware of the general principle of extremeness aversion. As a rule, consumers tend to avoid both the most expensive and the least expensive options in a category.

  - Marketers should also be aware that people tend to use the context to gauge their preferences relative to other people. In other words, if you're shopping for binoculars, you might ask

yourself how serious your bird-watching hobby is compared to the entire population of bird watchers. Your answer will be a factor in determining which pair of binoculars you buy.

- ○ This tendency makes sense, but researchers have found that people are not necessarily sensitive to overall prices when they apply this rule. In other words, they are often too focused on the prices of the local set they are considering.

- In evaluating prices, consumers also take into account price image, that is, your reputation for pricing. Researchers have found that when consumers don't have a well-defined reference price for a particular product, they assume that a price they encounter is consistent with the retailer's price image.
  - ○ For instance, when told the price of a carton of orange juice from a high-end grocery store and from a store with a moderate-price image, people evaluated the price differently, even though it was the same in both cases.

  - ○ These results mean that a store's price image should be managed just like a brand image. In other words, price images are not formed based only on a store's objective prices. Rather, consumers use many non-price cues when forming a price image, including the store's décor, its location, the level of service provided, and so on. Price images are best managed not just by managing prices but by managing all the price-related associations consumers might form with a brand.

Suggested Reading

Chernev, *Strategic Marketing Management*, chapter 10.

Dickson and Sawyer, "The Price Knowledge and Search of Supermarket Shoppers."

Dolan, "How Do You Know When the Price Is Right?"

Shiv, Carmon, and Ariely, "Placebo Effects of Marketing Actions."

Questions to Consider

1. Pick a product or service with which you are familiar. Think of two different target segments to which this offering might appeal. Assume that these two segments value the offering differently. What are some ways that you could price discriminate, charging these segments different prices according to their difference in willingness to pay?

2. Think about tactics you might use to avoid a price war. Imagine you are managing some product or service and your major competitor drops its price. What are all the ways you could respond to this threat without lowering your price? How could you keep your customers and attract new customers using other non-price tactics in the marketing mix? If it helps, get specific: Think about a particular product and target segment with which you are familiar.

Marketing Communications That Work

Lecture 58

Some of you may be surprised to find that we are discussing advertising this late in the section on marketing. But the placement of our discussion of advertising is a reasonable proxy for its relative importance in marketing decision making. Because advertising is so visible, many people mistakenly assume that it constitutes most of marketing, but that's not true. When marketing is done right, it starts well before any particular communication program is even conceived. It incorporates product design, pricing, distribution, and incentives—much more than just advertising. With that said, communication is still important; thus, in this lecture, we'll talk about some of the principles involved in doing marketing communications well.

Case Study: "Got Milk?" Campaign

- The process of communicating is interesting because it is a microcosm of the marketing process itself. Just as you need a marketing plan that includes a specific goal, a strategy to reach that goal, and a set of tactics designed to implement that strategy, so too, each communication effort requires its own communication

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Only after you have a strategy in place does it make sense to start designing an ad campaign, posting billboards, or sending out direct-mail catalogs.

plan, complete with its own communication goal, strategy, and tactics. We'll begin by looking at these elements in one successful ad campaign: the California Milk Processor Board's "Got Milk?" campaign.

- In the late 1980s and early 1990s, the per-capita consumption of milk declined by about two gallons per year, which translated to about $50 million in lost profit for the industry. As you can imagine, milk producers were concerned and tried to diagnose the problem.

- Milk's advertising in the late 1980s was targeted at children and teenagers and delivered the message that milk was healthy—good for strong bones, a great smile, and beautiful skin. This message seemed to have gotten through. In survey research conducted by the Milk Processor Board, 89% of respondents agreed with the statement "Milk is a healthy drink." Furthermore, a full 80% reported that they liked the taste of milk. Why, then, were people buying less of it?
    - This question brings us to the first part of a communication plan: Before you run any kind of customer communication initiative, you should know the goals for your communications. Are you running an awareness campaign, an information campaign, or a persuasive campaign?

    - The goal of your communication campaign should be consonant with the larger goal of your overall marketing plan, but it is usually more specific and targeted.

- The Milk Processor Board did some market research and found a number of possible reasons for the decline in milk consumption, but it zeroed in on the one problem that it thought could be addressed: rationing. Because milk is usually purchased one gallon at a time and shared across the household, consumption is highly sensitive to how much milk is available on hand. The goal of the board's campaign, then, was to manage rationing by reminding people to pick up milk every time they went to the store.

- As we said, a campaign needs not just a goal but also a strategy. And just like the larger marketing strategy, this includes a target and positioning. In some cases, the target for a communication campaign will be the same as the target for the marketing strategy, but sometimes, the target is a subsegment of the total target. Some popular products, such as milk, have several target markets. A campaign could try to reach all those targets, or it could communicate with just one of those groups. In the milk campaign, the target was parents.

- There was also a positioning for the "Got Milk?" campaign in that it promoted a simple message highlighting an advantage of milk over competitive beverages. For this campaign, the Milk Processor Board settled on milk as the perfect complement for other foods, such as cereals, cake, cookies, and sandwiches. That was milk's value proposition.

- With a goal and a strategy in place for the communications campaign, it was time for some tactical decisions. This is the creative question: How can we get this message out to our target? The tactics here included an award-winning series of "deprivation ads": In each ad, a person was shown enjoying some kind of delicious food but discovered, too late, that he or she had run out of milk. Each ad ended with the tagline "Got milk?" which served as a warning not to let the same fate befall the viewer.

- The ads were a tremendous success. The campaign actually brought about a 3% increase in sales, which translated into about $30 million. The ads were so successful in California, where they were launched, that the National Milk Processors Board picked them up and ran them nationwide.

- Unfortunately, the success was short-lived, possibly because the campaign lost its focus. Instead of the message that consumers should remember to buy milk, later ads promoted the health and

beauty benefits of milk, returning to the message that had been communicated in the 1980s. And the results were largely the same: People believed the messaging but failed to buy the product.

Commanding Attention

- One of the keys to successful communications is to command the attention of those watching or listening—and to do so without turning them off. And one way to do this is to always have news. If your commercials always inform customers of something important—or, at least, something that seems important on first glance—they are more likely to command attention.

- To ensure that you always have new information to share, you might try the strategy of *trivial innovation*. Several beer companies, including MillerCoors, have perfected this strategy. They don't change the recipe for beer, but they change other things about the product, such as bottling or packaging, in order to have some bit of news to promote in their ads.

- Budweiser gives us an example of a different strategy for getting consumers' attention. This company tends to not engage in as much trivial innovation for its products and packaging; instead, it produces ads that are destination entertainment and still promote the brand well. Think of Spuds MacKenzie, the Budweiser frogs, or the Wazzup?! guys. Budweiser creates cultural phenomena—always carefully and closely tied to the brand—that people want to watch and share with their friends.

Communication Templates

- One last thing to consider as you plan a communication campaign is to give yourself room for evolution if the campaign gains some traction. Even the best-loved ads get tiresome with sufficient viewing. In order to keep people's attention, it is often necessary to change things up a bit or refresh the idea. Some campaigns are flexible enough to do this in ways that hold true to the original or current goals and are still different enough to keep customers engaged.

- The best way to allow for evolution is to establish a template for communicating with your target customers instead of creating a single piece or even a single set of communications. This advice holds for all types of communications, including advertising, email communication, direct-mail catalogs, PR campaigns, and so on. When you establish the template, ask yourself: What about the messaging is core and should remain immutable, and what should be free to change over time?

- Among print advertisers, Absolut Vodka is perhaps the best example of a company that does templates well. For years, its print ads featured some visual variation on the iconic bottle, which took up most of the page. The bottle could be made out of flowers, a skyscraper, or mountains. Because the formula allowed for endless reinvention, the ads never got old and always attracted attention, while remaining consistent.

- An example of an ad campaign that seems to have evolved poorly is the Capital One Visa card commercials.
    - The original ads featured a barbarian horde descending on a hapless credit-card user. The commercials delivered the message that Capital One protects consumers from such dangers as fraud, identify theft, and high fees.

    - Over time, however, the focus of the campaign shifted. Instead of being symbolic of the dangers inherent in modern financial transactions, the barbarians became spokespeople for the card. They charged items to the Capital One card to rack up points to go on vacation or customized the card with pictures of their barbarian children. None of this made sense to the average consumer.

    - The campaign evolved poorly because it didn't follow a template. Instead, it established a group of central characters and simply let the wheels spin from there. From the customer's perspective, the result was confusing.

Summing Up Communications

- Designing and running a marketing communication campaign can be intimidating, but there is an established process. First, make sure you have a goal for your communications, whether you are designing a Super Bowl ad, a website, or a flyer. Ask yourself what problem you want to solve with your communication.

- Your communications should also always have a target and a value proposition. Sometimes, you will address your entire target or multiple targets, but often, you will run an ad or other communication effort targeted at just a subsegment of your entire target market.

- Only after you have a goal and a strategy for your communication efforts should you start to think about the creative—the tactics for your communications. The trickiest part of tactical communications is the trade-off between entertaining customers and informing them. If you fail to grab someone's attention, it really doesn't matter what else you try to do in your communications. As we said, you can attract attention by always sharing news or by providing people with social currency—something they can talk about with friends.

Suggested Reading

Chernev, *Strategic Marketing Management*, chapter 12.

Questions to Consider

1. Watch some commercials. If possible, try to watch several ads from the same campaign. (YouTube is a good source for this exercise.) Then, reverse-engineer the decision process used to come up with the campaign. What was the goal? Who were the target customers? On what value proposition are the ads positioned?

2. Pick a brand you know well and sketch out a new ad for that brand. Start with a goal—a specific problem you hope to solve with your ad—and choose a target. Then, describe the creative you would use. How would you grab attention without losing control of the message?

The Promise and Perils of Social Media

Lecture 59

In the last lecture, we talked about communications as a tactic. The principles we discussed in that lecture hold for all your communications efforts, whether traditional advertising, direct mail, or website design: You should always know who your target customer is for any particular communication effort, and you should customize your communication effort to provide value for that customer. But even though these general rules apply to all forms of communication with the customer, it's also worth looking at some of the nontraditional means of communication that marketers now have at their disposal: social media, word-of-mouth campaigns, viral videos, and so on. In this lecture, we'll explore some of these innovative ways of getting information to consumers.

Public Relations

- Nontraditional communications, such as social media, viral videos, and so on, typically reach customers only indirectly—through some intermediary, such as a reporter or a friend. As a result, these nontraditional, indirect modes of communication effectively add another layer of "customers" to be served. In this, they are similar to one of the oldest and most well-established means of nonadvertising communications: public relations.

- Not surprisingly, companies love public relations. After all, aside from whatever you pay your PR firm or the person writing the press releases, it's free! Most companies attempt to take advantage of PR by mailing press releases to the media, highlighting company achievements and including quotes from executives or customers.

- The problem with this approach is that companies often forget who the "customer" is for their press releases. In the case of PR, the press is the customer—reporters, cable news producers, and industry trade writers. Far too many companies are completely

centered on themselves when they engage in PR efforts. They try to tell reporters what the company is excited about, which doesn't interest the news media.

- If you want your PR to take off, you must give reporters something they will be interested in writing about.
  - For example, in the midst of an economic downturn, reporters are probably looking for stories about "green shoots" in the economy—evidence that business may be picking up. Instead of sending out a generic story about your new product launch, contact those reporters who would be most likely to write about the economy and tell your story from that slant.

  - Did your new product launch allow you to hire more people? Do you plan to open a new factory that will create jobs? Reporters will be interested in those kinds of hooks and are more likely to tell your story to potential customers.

- One of the most astounding successes in recent PR history was that of American Giant, a small, independent sweatshirt maker in San Francisco. Instead of contacting fashion reporters, the company sent a press release to Farhad Manjoo, a technology columnist for *Slate* magazine.
  - Manjoo was intrigued by the fact that American Giant used the Internet to sell directly to customers from the factory, bypassing the distribution costs faced by most apparel makers. He also liked the idea that the company had hired an industrial designer from Apple to assist in the design of the sweatshirts. In December of 2012, he wrote a gushing tribute to both the product and the company in a column entitled "This Is the Greatest Hoodie Ever Made."

  - The column went viral almost immediately. It was tweeted, emailed, posted on Facebook and picked up by ABC and NPR. Within a very short time, American Giant sold almost everything it had in inventory; it then took preorders for three to six months in advance of delivery.

- ○ The difference between American Giant's astonishing PR success and the deafening silence that most firms reap comes from applying a basic marketing principle: Recognize your customer. For PR campaigns, the reporter, columnist, or producer is the customer.

Viral Marketing

- Viral marketing has been a common tactic for several years now. The idea is to create something—an online video, a web game, a clever tweet, an op-ed, or even just an experience or story—that people will find worthy of forwarding or talking about to others. Those others then push the content on to still others, and the marketing message spreads, like a virus, until it has infected the whole market.

- As you can imagine, getting viral marketing to work is easier said than done. Most often, when companies or ad agencies announce their intentions to start a viral campaign, they're talking about a communication effort that they are unwilling to fund.

- Like successful PR campaigns, successful viral marketing campaigns must serve two customers or, rather, two sets of customer needs. There must, of course, be the message about the product, service, or brand—the marketing message. But there is also an additional social need that must be met with the communication effort. People need to derive some value from sharing the message. That value comes from sharing content that is funny, emotionally moving, profound, insightful, or just plain interesting.

- Just as you should anticipate the value that a reporter might seek to gain from a press release, you should also know exactly what value customers would get from communicating your would-be viral message to others. Once again, the message of the company is often not at all interesting to the customers whom you want to spread the message. The key here is to give customers content that they will want to give as gifts to their friends.

Destination Content

- Another change in marketing communication over the last few years is the growing prevalence of destination content. Increasingly, companies are looking to cut through the clutter of advertising by creating on-message content that people actually seek out.

- One version of this strategy is to create advertisements that are so entertaining—funny, moving, or amazing—that people will go online and look for the ads because they hear others talking about them or because they want to see the ads again.
    - One prominent example was a Volvo truck ad that featured Jean-Claude Van Damme standing on the side mirrors of two moving trucks. The trucks slowly drifted apart until the movie star was doing a perfect split between two trucks rolling down the asphalt.

    - In cases like this, only a small fraction of the total viewership comes when the ads air on television. Most of their reach happens later, online, where customers seek out the advertising content as destination entertainment.

- Such dual-channel advertising is not the only way to develop destination marketing content. Increasingly, firms are creating entertaining content that is designed for online viewing only.
    - A prominent example here was a series of short films created by BMW and distributed over the Internet. The films were written and produced by top Hollywood talent and were praised by *TIME* magazine and *The New York Times*.

    - Because of the quality, these films became destination entertainment. People sought them out, watched them, and forwarded them to friends. The shorts were watched more than 11 million times in the first four months after they were launched.

- The blender manufacturer Blendtec has also created destination entertainment but on a very low budget. Its “Will It Blend?” webisodes feature the company’s founder putting various household objects, such as a box of light bulbs, a six-pack of soda, or an iPhone, into a blender.
    - The short webisodes are bizarre, funny, and innovative. And most important, they illustrate exactly how good Blendtec’s products are at blending.

    - Within a week of the first posting on YouTube, Blendtec’s video had been viewed more than 6 million times. Within two years, sales had gone up 700%. The campaign, which involved no professional advertising firm and had practically no budget, won a Clio award, one of the most prestigious awards in advertising.

- Both BMW and Blendtec created value for the customer by actually being entertaining. This seems basic, but traditional advertising is primarily about delivering the message. That is completely different from destination marketing, where the entertainment value of the communication must be the primary concern. If people don’t seek out your offering and tell their friends about it, then it won’t matter what the message is. You must create something worth seeking out.
    - But just as an on-point message is useless without the entertainment value to draw people in, creating something that is entertaining without delivering the marketing message is the same as throwing money away.

    - What made both of these campaigns successful is that they were able to entertain in a way that emphasized the marketing messages.

Social Media

- As a communication tactic, social media has several advantages, including the fact that it's inexpensive. It's also a two-way communication channel. If you pay attention, you can learn as much from your customers through social media as your customers are learning from each other. It is, thus, part marketing communications and part marketing research.

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Getting customers to tweet about your product or post something about it on Facebook can be influential to other customers and costs you very little.

- Despite its advantages, however, social media also carries the potential for companies to misuse it. One of the most common errors, for example, is the failure to base social media strategy on the larger marketing goals of the company. Many firms hire specialists to design and implement their social media strategy, but often, these specialists are removed from the rest of the marketing efforts. As a result, their digital or social media campaigns don't advance a company's overall marketing strategy.
    - The clearest manifestation of this phenomenon is the obsession with new metrics specific to various websites or platforms, such as the Klout score or the number of Facebook likes.

    - There is nothing wrong with getting people to like your brand on Facebook; it opens a channel for further communication with those customers and increases the chances that their friends will see the association and become more interested in the brand. But Facebook likes are not an end unto themselves.

The fact that they are easy to measure does not make them appropriate metrics for a campaign—and is certainly not justification for seeking them out.

- Another error companies make with social media is believing that they must be a part of every new platform or forum for communication. Such decisions should depend on whether the target customers actually participate in a particular social media platform and will be open to receiving company messaging on that platform. You should always have your eyes open for new opportunities, and if your customers are congregating in some real or virtual space, you should try to be there. But virtual spaces are just like real spaces, and your brand doesn't necessarily belong in all of them.

Suggested Reading

Chernev, *Strategic Marketing Management*, chapter 12.

Questions to Consider

1. Choose a product or service with which you are familiar, and think of how that offering is positioned: What are its key selling points relative to its competition? Using that key differentiator as a starting point, get creative and brainstorm some content that is both relevant to the brand and likely to be sufficiently entertaining that it will be shared and talked about by customers.

2. Practice writing a press release that creates value for a particular type of reporter. What are the needs of reporters in that field? How can your press release help them meet their needs?

Innovative Marketing Research Techniques

Lecture 60

In these lectures, we've talked about strategy—knowing who your customers are and what they value. We've also talked about tactics—the mix of marketing variables, such as price, brand, and communication, used to implement strategy. As we've seen, introspection and logic can get you a long way toward creating a marketing strategy and developing marketing tactics, but it's also true that whenever possible, you should base your decision making on solid market research. There's simply no substitute for talking to your customers and observing them as they buy and use your products. Thus, we'll end the marketing section of the course with the activity that you will generally undertake first—conducting market research.

Qualitative Research

- Qualitative research methods include customer observations, focus groups, ethnographies, and projective techniques. The data produced from qualitative methods are most often expressed in qualitative terms: stories about typical customer experiences and representative quotes from customers. In general, qualitative methods are useful for making new discoveries and reaching a better understanding of customers.

- Some companies have a culture that embraces qualitative research because they believe that these methods produce uniquely useful insights. Consider Procter & Gamble's official research philosophy: "We live with our consumers and try to see the world and opportunities for new products through their eyes. At P&G, the CEO is not the boss—the consumer is."
    - The idea of "living with consumers" and "seeing the world through their eyes" is what qualitative research is all about, and you don't get that by conducting some surveys or looking at sales data.

    - The goal of qualitative research is to shed all the baggage that comes with working for a firm, of being involved in marketing a product, of understanding all the behind-the-scenes decisions that lead to an offering coming to market. The idea is to put all of that aside and rediscover the offering from the customer's perspective.

- None of this is to say that qualitative research is superior to quantitative techniques. Quantitative research and qualitative research and are not substitutes for each other. The best scenario is one in which marketers employ many different types of research methods and use them iteratively, constantly looking for new insights and testing those insights with additional research, before starting over again.

- The goal of qualitative research is to develop a rich understanding of your customers *in situ*, that is, as they shop, consume, and talk to others about your offering. Some marketers refer to the output of qualitative research as "thick descriptions," which often include direct quotes from customers. What you're seeking is an accurate representation of the experience of the consumer.

Focus Groups

- The most common qualitative research method used in marketing is the focus group. This is a gathering of consumers, usually in groups of 5 to 10, for a candid discussion of some topic, product, issue, or political candidate. Typically, focus groups consist of only those customers who are in the target segment.

- Focus groups have a discussion leader, who guides the participants through a series of questions or tasks. If the group was convened to discuss a product, there may be samples for the participants to experience and react to. Historically, focus groups have been held in conference rooms, often with a one-way mirror to allow interested parties to watch the proceedings. More recently, it has become common to conduct these groups in less formal settings or even online, using video conference software.

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Quantitative research methods, such as surveys, have well-defined criteria that must be met if the data are to be valid, interpretable, and generalizable.

- Focus groups are a good method for seeking clarification of some particular idea or question. In this way, they are conceptually similar to surveys. In both cases, consumers are asked a specific set of questions to gain insight into a particular group of topics. Focus groups are inferior to surveys in that the results tend to be less generalizable, but they also allow marketers to get more in-depth information from participants.

- Both surveys and focus groups are limited in that they are primarily guided by the researcher. The marketer decides what questions to ask and which topics to cover, which means that surveys and focus groups tend to be bound by the limits of the marketer's imagination. It can be difficult to discover radically new and surprising insights if you have to define all the questions that will be asked in advance. Other qualitative research methods are designed to get around this limitation by being more open-ended and less directed by the researcher.

Customer Observation

- Customer observation is a fairly simple method of conducting qualitative research. The advantage of using observation over surveys or focus groups is that people aren't always aware of their behavior. If you observe customers, as opposed to asking them direct questions, you can sometimes gain surprising insights.
    - For example, a baby food company hired observers to surreptitiously watch parents as they selected baby food in the grocery store. Interestingly, the observers noticed that many of the parents treated the jars of baby food as if they were fresh produce, squeezing them, peering at them to look for bruised spots, and even sniffing them.

    - If the company had asked these customers how they chose baby foods, they probably would have provided answers related to fresh ingredients and good nutrition. None of the parents would have admitted that they also squeeze the jars and try to smell the contents through the lid because they probably weren't even aware of this behavior.

    - The company used this qualitative research to redesign its packaging. The jars were made to look rounder and more organic, a bit like plums or apples, and the labels were made smaller to make it easier for parents to see inside the jars.

- Observations can be done live, in stores or restaurants or on the factory floor. Wherever your customers purchase or consume your product or service, you can observe them. Many firms also apply observational techniques to recordings of customer interactions. For example, banks use recordings of interactions at ATMs to try to improve customer experiences with the machines.

- One of the best-known proponents of observational research methods in marketing is Paco Underhill, whose qualitative research has resulted in a number of interesting observations about the way people shop.

- For example, Underhill found that customers generally require a "decompression zone" when they enter a retail space. Essentially, consumers are completely unaware of any signage, displays, or special offers that are placed within the first few feet of a store's entrance. People seem to need a space to become accustomed to being in the store. If you try to reach them when they are decompressing, they will be blind and deaf to your appeals.

- Another famous Underhill finding is the "butt-brush" effect. Underhill found—not surprisingly—that people become uncomfortable if other people or things touch their derrières when they are in public spaces. But retailers often set up displays in high-traffic areas that require customers to lean forward to examine the merchandise. Observation proved that people tend to move away from these displays quickly to avoid the possibility of "butt brushing." Moving these displays out of the flow of traffic allows customers to browse without feeling exposed.

Ethnographies

- An even more interactive form of observational qualitative research is ethnography. This is a research tool developed by cultural anthropologists to understand the cultures, traditions, behaviors, and beliefs of groups of people.

- The idea behind ethnographies is that we are all members of various cultures that are alien to, and misunderstood by, those outside that culture, including marketing managers and product designers. By treating your customers as if they are members of an exotic culture, you are free to ask a wide range of questions in order to see things in a new light.

- Ethnography is also known as *participant observation*. In other words, you are not merely observing the tribe of consumers but trying to become part of that tribe yourself. Some companies, such as Procter & Gamble and Harley-Davidson, embrace participant observation for the insights it generates. Every year, top executives at Harley-Davidson go on a three-day ride with Harley customers, trying to actually live the experience of customers for a short period of time.

Projective Techniques

- In addition to customer observations, focus groups, and ethnographies, there are a number of projective techniques that fit into the broad category of qualitative research. The basic theory behind projective techniques is that sometimes people are guarded when asked direct questions about a product, brand, or experience. Asking indirect questions may reveal more about someone's true thoughts and feelings.

- Self-report biases are well-documented in studies that ask people directly about their own preferences or behavior. Some of these concerns can be reduced if you ask people to describe the preferences or behavior of a "typical" consumer.

- You might also invite customers to clip pictures from magazines and make collages that represent a particular product or brand. You then examine the collages and ask what the images mean. The collage becomes a springboard for discussing ideas and feelings that the consumer may not otherwise be able to articulate. Data collected in this manner may be harder to interpret but may also present radically new findings.

- There are no rules for developing projective techniques. This is an opportunity to get creative. For example, you might ask customers to compare the product to an animal. Think of new and different ways of getting people to project their opinions through indirect means.

Companywide Marketing

- Many decisions made by people throughout a company—from human resources to accounting to finance to operations—have the potential to influence the value customers derive from their interactions with the company. But if people outside of the marketing department don't know the marketing plan, what hope will they have of making smart decisions? Marketing insights should be infused throughout the company.

- Everyone in an organization should be able to answer the three questions we've focused on throughout these lectures: Who is the customer? What does the customer value? And how are your company's offerings differentiated from those of the competition?

- The crucial need for companywide marketing was summed up by David Packard, cofounder of Hewlett-Packard: "Marketing is too important to be left to the marketing department."

Suggested Reading

Manzi, *Uncontrolled*.

Underhill, *Why We Buy*.

Questions to Consider

1. Practice observing customers. Choose an interesting site (a coffee shop, a bookstore, a concert hall, or an aisle in the grocery story) and simply watch people. See how they interact with one another and with their surroundings. Look for commonalities among people. What are some generalizable insights about customers in that setting? Could you use your insights to make any marketing recommendations?

2. Participate in some market research. Look online for various companies that allow you to participate in online surveys and focus groups. (You may even get a little money for participating!) Your goal when taking these surveys and participating in these focus groups is to learn as much about the mechanics of the research as you can. What types of questions are asked? How are the surveys or sessions organized? What was the length? How did the survey start? What features of the research did you like? Are there things you would have done differently? Now that you have seen how other firms do research, shamelessly steal the techniques and methods you think worked well and use them when designing your own research.

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